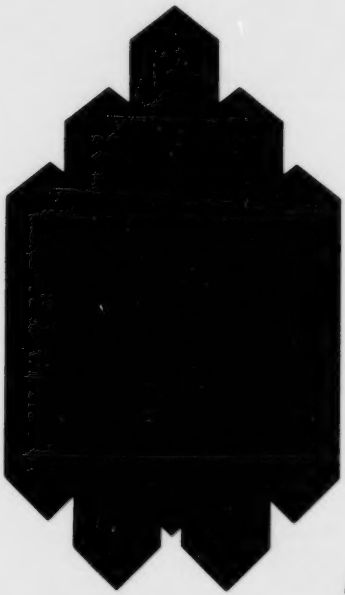
Focus on Follow-through

Policy Review and Outlook, 1988

C.D. Howe Institute



Edward A. Carmichael
and
Katie Macmillan

88-02021/

C.D. Howe Institute

The C.D. Howe Institute is an independent, nonprofit, research and educational institution. Its goals are to identify current and emerging economic and social policy issues facing Canadians; to analyze options for public- and private-sector responses; to recommend, where appropriate, particular policy options that, in the Institute's view, best serve the national interest; and to communicate the conclusions of its research to a domestic and international audience in a clear, nonpartisan way.

While its focus is national and international, the Institute recognizes that each of Canada's regions may have a particular perspective on policy issues and different concepts of what should be national priorities.

The Institute was created in 1973 by a merger of the Private Planning Association of Canada (PPAC) and the C.D. Howe Memorial Foundation. The PPAC, formed in 1958 by business and labor leaders, undertook research and educational activities on economic policy issues. The Foundation had been created in 1961 to memorialize the late Rt. Hon. Clarence Decatur Howe, who served Canada as Minister of Trade and Commerce, among other elected capacities, between 1935 and 1957.

The Institute encourages participation in and support of its activities from business, organized labor, associations, the professions and interested individuals. For further information, please contact the Institute's Membership Coordinator.

Grant L. Reuber is Chairman, Maureen Farrow is President and Treasurer, and Brenda Huff is Corporate Secretary.

C.D. Howe Institute/Institut C.D. Howe

125 Adelaide Street East
Toronto, Ontario
M5C 1L7
(416) 865-1904

Suite 900
555, ouest blvd. Dorchester
Montréal, Québec
H2Z 1B1
(514) 879-1254

P.O. Box 1621
Station "M"
Calgary, Alberta
T2P 2L7
(403) 233-8044

Focus on Follow-through

Policy Review and Outlook, 1988

Edward A. Carmichael
and
Katie Macmillan

C.D. Howe Institute

C.D. Howe Institute publications are available from:

Prentice-Hall Canada Inc.
1870 Birchmount Road
Scarborough, Ontario
M1P 2J7
(416) 293-3621

Institute publications are also available in microform from:

Micromedia Limited
158 Pearl Street
Toronto, Ontario
M5H 1L3

Canadian Cataloguing in Publication Data

Carmichael, Edward A.
Focus on follow-through

(Policy review and outlook; 1988)
Bibliography: pp. 95-99.
ISBN 0-88806-176-5

1. Canada - Economic policy - 1971 - .
2. Canada - Economic conditions - 1971 - .
I. Macmillan, Katie, 1956- . II. C.D. Howe Institute III. Title. IV. Series.

HC115.C37 1988 338.971 C88-093400-X

© C.D. Howe Institute, Toronto, Montreal, and Calgary, January 1988.
Quotation with appropriate credit is permissible.
Printed in Canada.

Contents

Foreword v

1 *The Coming Correction* .....
Introduction 1
Outline of the *Policy Review and Outlook* 1
The Canadian Economy in 1987 2
Correcting Global Imbalances 3
Looking Ahead to 1988 8
..... 21

2 *New Rules of the Game: Free Trade and Tax Reform* 22
Understanding the New Environment 23
A Brief Digression on Methodology 24
Overall Economic Impact 27
Industry Impact 32
Conclusions and Unfinished Business 47

3 *Facing Up to Global Agricultural Realities* 49
Introduction 49
An Overview of Canadian Agriculture 50
The Challenges Facing Canadian Agriculture 52
Agricultural Trade 63
The Goals and Instruments of Canadian Agricultural Policy 67
A New Strategy for Canadian Agriculture 71
Concluding Comments 75

4 *Focus on Follow-through* .....
The Economic Environment 76
The Policy Agenda 76
Conclusion 77
..... 93

Figures
1 The Federal Budget Deficit, 1982–87 6
2 Savings-Investment Balance, 1981–87 7
3 U.S. Current Account and Net Foreign Assets, 1970–92 10

4 U.S. Dollar Exchange Rates for Canada, West Germany, and Japan, 1980–87 12
5 Cash Receipts from Crops in Canada, 1980–87 51
6 Cash Receipts from Livestock and Livestock Products in Canada, 1980–87 52
7 Federal Deficit Projections, fiscal years 1985–86 to 1991–92 89

Tables

1 Contributions to Growth of Real National Income per capita, 1980–87 4
2 U.S. Merchandise Trade Balance by Area and Commodity, 1986 19
3 Potential Macroeconomic Impact of Free Trade and Tax Reform 28
4 Potential Impact of Free Trade and Tax Reform on Output by Sector 33
5 Trade Barriers in Selected Canadian and U.S. Manufacturing Industries 41
6 Potential Impact of Free Trade and Tax Reform on Output in the Construction and Services Industries 45
7 Producer Subsidy Equivalent Levels by Country and Commodity, 1982–84 55
8 The Cost of Purchasing a Basket of Food Items in Various Countries, 1983 68
9 Federal and Provincial Government Agricultural Support, 1980–82 and 1985–87 69

Bibliography 95

Members of the C.D. Howe Institute 101

Foreword

Since the first edition of the *Policy Review and Outlook* in 1974, a major objective of the publication has been to identify key issues on the economic policy agenda in the year ahead. This year's *Policy Review and Outlook* was written during a period of great uncertainty. As it was being prepared, Canada and the United States reached a preliminary agreement on the elements of a free trade agreement on October 3, world stock markets experienced an unprecedented decline on October 19, and government officials worked round the clock until early December to hammer out the final details of the Canada-U.S. Free Trade Agreement (finally initialed on December 10) and legislation to implement the first stage of tax reform (tabled in the House of Commons on December 16).

Had the Canadian and U.S. trade negotiators not reached agreement a few minutes before midnight on October 3 and subsequently agreed on the legal language in December, the economic policy agenda for 1988 would have been considerably different from that presented here. The title of this book might well have been *Picking Up the Pieces*.

As 1987 drew to a close, however, with both free trade and tax reform moving forward, there was little doubt that the major focus of economic policy in 1988 should be on following through on the important economic policy initiatives of 1987 and earlier years. Specifically, the top priorities in 1988 should be to implement the free trade agreement, to introduce detailed proposals for federal sales tax reform, to demonstrate renewed commitment to reducing the federal budget deficit and the growth of public and foreign indebtedness, and to develop appropriate longer-term adjustment policies for agriculture.

The potential for severe turbulence in world financial markets that came to the fore in October 1987 has not gone away; therefore, the economic environment for policymaking will continue to be volatile. In the Institute's view, the best defense against the inevitable economic shocks is a good offense based on sound domestic policies that promote competition and flexibility in the face of changing domestic and international market conditions.

Ted Carmichael, the Institute's Vice-President and Director of Policy Research, again has been responsible for the preparation of the *Policy Review and Outlook*. This year, he was ably assisted by Katie Macmillan, Policy Analyst, who wrote Chapter 3 dealing with the new global realities facing Canadian agriculture. The manuscript was edited by Barry Norris, Director of Publications, and efficiently prepared by Cordelia Sharpe.

The conclusions and recommendations presented here are based on the results of the Institute's active research and publications program in 1987, as well as new research. The authors have benefited from discussions with a wide range of individuals, including members of the C.D. Howe Institute Policy Analysis Committee. As always, the conclusions are the responsibility of Institute staff; they do not necessarily represent the views of the Institute's members or directors.

Maureen Farrow
President

1

The Coming Correction

The unprecedented international imbalances of the first half of the 1980s have fundamentally altered the structure of the world economy....The forces set in train by these historic changes will dominate the course of global economic events for the next five to ten years.[1]

C. Fred Bergsten
Spring 1987

Introduction

In looking ahead to 1988, Canadians might justifiably reflect that they stand at a threshold. Some look forward with optimism and confidence to the new trade and employment opportunities. Others view their economic prospects as threatened by the possibility of a global recession, by the subsidies war in agriculture, by continuing U.S. protectionism, or by competitive pressures arising from free trade with the United States.

The message of *Policy Review and Outlook, 1988* is that, in spite of global and domestic economic uncertainties, Canadian policymakers should follow through with the major trade, tax, and deficit-reduction initiatives they have undertaken over the past three years. For the private sector, the implication of this message is that the success or failure of this economic strategy will depend increasingly on how businesses, labor unions, and working Canadians respond to the changing economic environment and the opportunities it brings.

The Canadian economy has already responded to a string of economic shocks and policy changes in the 1980s. These include the second oil shock and the damaging National Energy Program, the soaring inflation and interest rates of 1981 and the subsequent economic collapse of 1982, the phasing in of a 40 percent average cut in all Canadian tariffs with the implementation of the Tokyo Round of multilateral trade liberalization, the collapse of world oil and grain

[1] C. Fred Bergsten, "Economic Imbalances and World Politics," *Foreign Affairs* 65 (Spring 1987): 770.

prices in early 1986, and the sharp rise of U.S. nontariff protectionism beginning in 1985.

Canada's relative success in adjusting to these shocks is due largely to the flexibility of its labor market and the dynamism of its small business sector. In recent years, as many as 5 million Canadians have changed their employment at least once during the course of a year. Changing jobs every few years has become the norm for Canadian workers, and this adaptability has helped to accommodate necessary adjustments in the industrial structure of the economy. An equally important contribution to Canada's recent economic success has been the growth of employment opportunities in the small business sector. Studies of the role of small business in creating new jobs show that companies with less than 20 employees have contributed more than 85 percent of the new jobs over the past decade. Indeed, new business startups are responsible for the majority of these new jobs. If the recent past is any guide to the future, over half of the net new jobs created in the next decade will be in companies that do not exist today.

Canada's ability to anticipate and respond effectively to change will be tested again in 1988. This year's *Policy Review and Outlook* examines several forces for change that will be at work in the year ahead.

Outline of the *Policy Review and Outlook*

The direction the Canadian economy and economic policy will take in 1988 and beyond will be influenced heavily by the historic policy initiatives and global economic developments of 1987. The Canada-U.S. Free Trade Agreement and major reform of personal and corporate taxes will alter the rules of the economic game significantly and will influence economic performance for many years to come. The global economic imbalances that contributed to the stock market crash of October 1987 will have to be corrected. This will occur either through improved macroeconomic management or through further painful disruptions in markets. Once the correction of the U.S. trade deficit begins, major shifts will occur in resource allocation in the United States that will have implications for its major trading partners, including Canada.

In this chapter of *Policy Review and Outlook, 1988*, we examine Canada's strong, but unsustainable, economic performance in 1987,

and its vulnerability to external shocks created by large and growing public and foreign indebtedness. We then examine why a major correction in global trade imbalances — particularly in the U.S. trade deficit — is both necessary and inevitable, and the implications of this correction for the United States' major trading partners.

The pressures that the correction in the U.S. trade deficit will create for some Canadian industries will shape the environment within which these same industries will have to adjust to two fundamental domestic policy changes: bilateral free trade with the United States and tax reform. Chapter 2 investigates the combined effects of these two policy initiatives. The analysis demonstrates that it will be easier for Canadian industries to adjust to the more competitive trade environment and more neutral corporate tax environment if the federal government moves quickly to complete its tax reform initiative by reforming Canada's antiquated and economically damaging sales tax system.

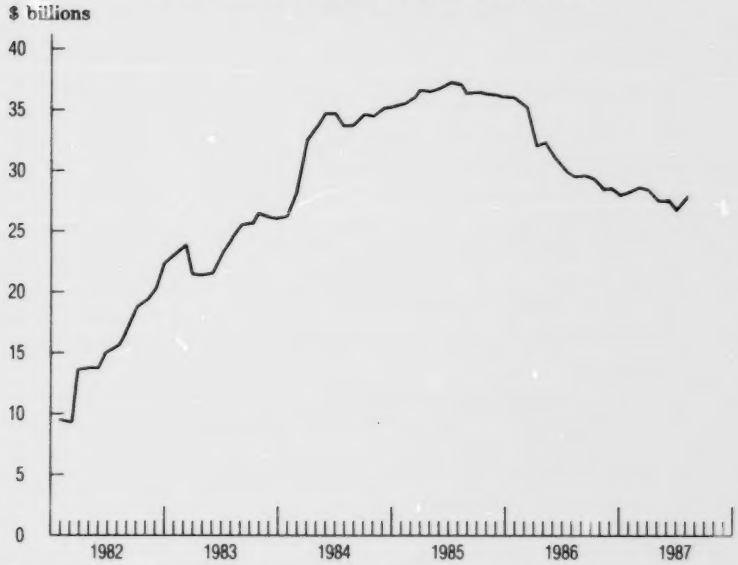
The state of world agricultural markets is a major policy issue that has not been dealt with fully by the tax reform and trade initiatives. Global excess supply, agricultural subsidy wars, and increased production capacity in many countries that were formerly large food importers all pose significant challenges for Canadian agriculture. Chapter 3 assesses these challenges, the short-term need for government support, and the medium- and longer-term need to adjust to changing global agricultural realities.

In the final chapter, we propose an agenda for Canadian economic policy in 1988. It is an agenda that focuses on following through with the initiatives on free trade, tax reform, and budget deficit reduction, and on facilitating the positive economic adjustments that lie ahead.

The Canadian Economy in 1987

Economic performance in Canada in 1987, the fifth consecutive year of economic expansion, was by many measures the best of the decade. Real economic activity grew more than 5 percent at annual rates over the first nine months of the year. The growth was broadly based, but was particularly evident in an unsustainable rate of increase in the demand for housing and consumer goods, fueled by a sharp drop in the personal savings rate. Business nonresidential

Figure 1
The Federal Budget Deficit, 1982–87

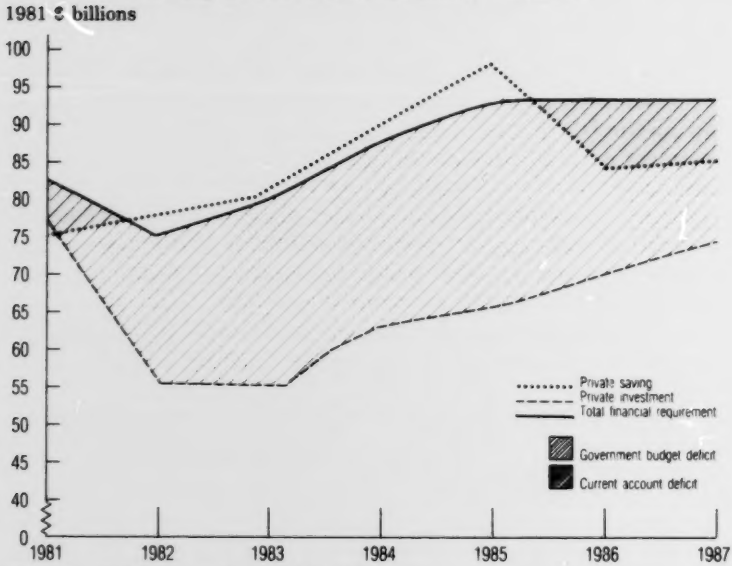


Source: *Bank of Canada Review*, various issues.

A major source of vulnerability is Canada's failure to reduce its public-sector budget deficit significantly. The federal budget deficit has declined, as shown in Figure 1, but a deficit of $29 billion — 5.4 percent of gross domestic product (GDP) — after five years of economic expansion is unprecedented in Canadian history. Each year's deficit adds to the public debt, which will reach $295 billion, or 55 percent of GDP, by the end of the 1987–88 fiscal year. Annual interest payments on the federal debt now exceed $28 billion. Rising interest rates in mid-1987 demonstrated that, even when the economy and federal revenues are growing rapidly, a rise in interest rates and the consequent rise in interest payments on the huge federal debt can prevent significant improvement in the deficit.

The deficit must be financed. In the process, governments compete for savings with private investment requirements. Private savings measured in constant dollars have declined over the past two

Figure 2
Savings-Investment Balance, 1981–87[a]



[a]Data for 1987 refer to the first half of the year.

Source: C.D. Howe Institute, based on Statistics Canada, *National Income and Expenditure Accounts*, Cat. no. 13-001, Second Quarter 1987.

years, as shown in Figure 2. As private investment has picked up from the sharp decline of 1982, governments have not reduced their borrowing requirements substantially. Since late 1985, total private savings have been insufficient to finance combined private investment and government borrowing requirements. This has meant that foreign capital inflows have been needed to finance the gap between domestic savings and financial requirements. In 1986 and 1987, these capital inflows totaled $10 billion each year. The flip side of these capital inflows is an equal current account deficit in the balance of payments. These deficits and the corresponding capital inflows are adding to Canada's vulnerability by increasing its foreign indebtedness. By the end of 1987, this indebtedness reached

$220 billion, *making Canada the world's second-largest debtor country after the United States.*

At this stage, one must ask whether the boom of 1987 that preceded the stock market crash, and the attitude of well-being that it generated in parts of Canada, represented anything more than a fool's paradise. Can Canadian governments go on indefinitely borrowing funds, which could have been used to finance domestic investment and job creation, to finance transfers to individuals for their personal consumption? Can Canadians go on borrowing abroad at recent rates without having to curtail consumption at some future date in order to service the foreign debt? The answer to both questions, of course, is that they certainly cannot.

If these trends cannot continue indefinitely, what then will be the sequence of events that brings a turnaround? For the answer, one must look beyond Canada's borders. Canada's budget and current account deficits will be reduced, not in isolation but in the context of a correction of much larger global economic imbalances.

Correcting Global Imbalances

> *Correcting the current imbalance assumes that America can embark on an enormous shift from consumption to savings, and that this shift will not throw the world's economy into a tailspin, either by trade-led recessions in the industrial countries or by a chain of debt defaults among the less-developed countries. The alternative to this daunting scenario, of course, is the crash: a huge plunge in the dollar, unaffordable imports, a long recession, garrison protectionism, rampant inflation, and a marked decline in American living standards.*[4]
>
> Peter G. Peterson
> October 1987

In October 1987, the world's financial markets recognized that the unsustainable global economic imbalances that had been growing since 1982 were not turning around quickly enough. A few economists had been warning for several years that the huge external (trade and current account) imbalances among the major industrial countries and the huge internal (savings-investment)

---

[4]Peter G. Peterson, "The Morning After," *The Atlantic Monthly*, October 1987, p. 46.

imbalances within these countries could not be sustained.[5] What became evident in 1987, and what may have contributed more than anything else to the correction in world stock markets on October 19, was the realization that the chances were slim that the imbalances would be turned around without either a U.S. recession, a further sharp drop in the U.S. dollar, or both.

While stock markets settled down somewhat after October 19, the question of how to reduce the U.S. current account deficit — and the Japanese and West German current account surpluses — remains. To address this question, we need to examine how the U.S. economy got into its current unsustainable configuration. Next, we need to examine ways in which current account imbalances could be corrected, and the implications for U.S. trade, economic growth and living standards. Finally, we need to consider the impact that necessary adjustments in the U.S. economy are likely to have on the Canadian economy.

How the Imbalances Arose

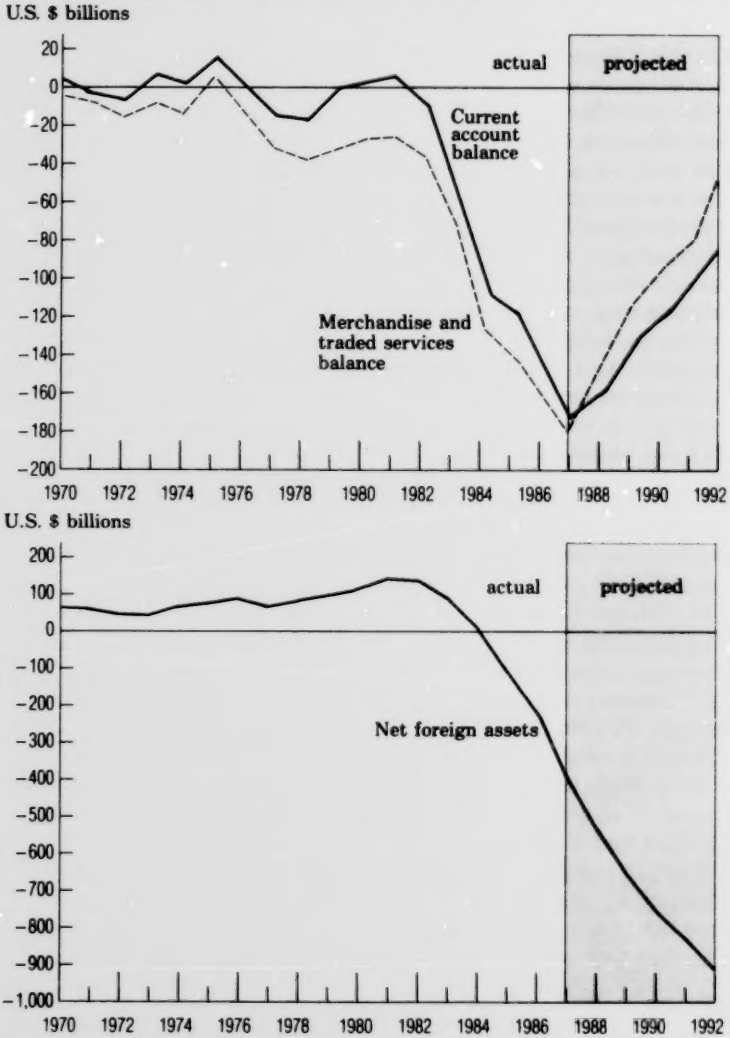
Global imbalances of the size recorded since 1983 are without precedent in the postwar era. In 1970, the U.S. current account was virtually balanced, registering a small surplus of $2.3 billion,[6] as shown in panel (a) of Figure 3. This surplus was the net result of a $6.3 billion surplus of foreign investment income — based on net foreign assets of $59 billion — and a $3.9 billion deficit on merchandise and traded services. During the 1970s, the United States' current account balance vacillated from small surpluses to small deficits. By 1981, the current account was again virtually in balance, showing a small surplus of $6.3 billion. The foreign investment income surplus had grown to $34.1 billion — based on net foreign assets of $141 billion — while the deficit on merchandise and traded services had slipped to $27.8 billion.

The U.S. economy came out of the 1981–82 recession like a locomotive, pulling the economies of the other major industrialized countries out of recession. This performance was the result of two factors. The first was a highly expansionary fiscal policy: the U.S. budget

[5]See Stephen Marris, *Deficits and the Dollar: The World Economy at Risk*, Policy Analyses in International Economics no. 14 (Washington, D.C.: Institute for International Economics, 1985).

[6]All dollar amounts throughout the remainder of Chapter 1 are in U.S. dollars, unless otherwise specified.

Figure 3
U.S. Current Account and Net Foreign Assets, 1970–92



Source: *Survey of Current Business* (U.S. Department of Commerce, Bureau of Economic Analysis), various issues.

deficit increased to $195 billion in 1983 from $60 billion in 1981. The second was an accommodative monetary policy: the U.S. prime interest rate declined to 10.5 percent in mid-1983 from 20.5 percent in mid-1981. Interest rates also declined in the other major industrialized countries, but both Japan and West Germany tightened their fiscal policies and reduced their budget deficits.

The result is by now well known. Strong growth in the U.S. economy led to large increases in imports that were not offset by increased exports to U.S. trading partners. At the same time, the strong growth of U.S. private investment coincided with increased public-sector borrowing to finance the budget deficit, resulting in large inflows of capital to the United States. The strong demand for capital pushed the U.S. dollar higher in foreign exchange markets, further exacerbating the growing U.S. trade deficit.

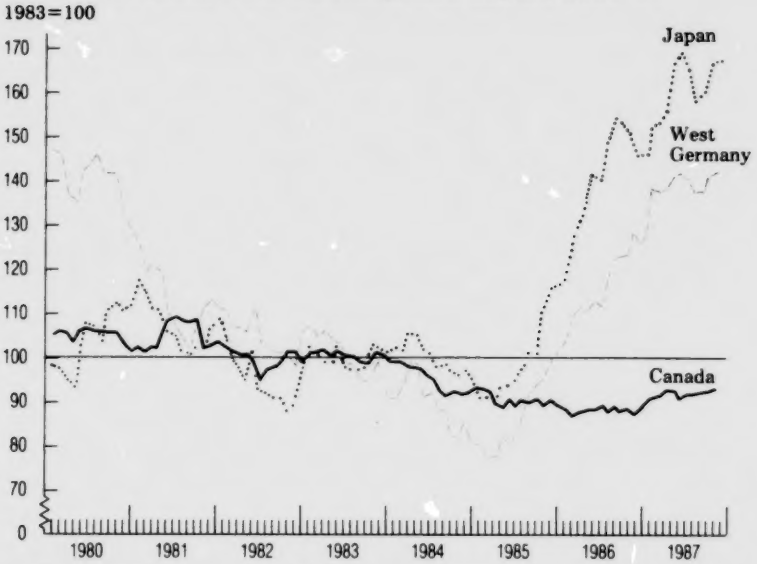
By the end of 1984, the U.S. current account deficit had increased to $107 billion. In three years, the huge increase in U.S. foreign borrowing had wiped out that country's net foreign asset position, as shown in panel (b) of Figure 3. In early 1985, at about the time the United States became a net debtor, the U.S. dollar began to fall in foreign exchange markets, as shown in Figure 4. The immediate effect of the dollar's decline was to raise the price of imports, further worsening the trade deficit. It was hoped, however, that the sharp fall in the dollar would eventually bring about a sharp decline in the U.S. current account deficit, although this view never adequately explained how the need for capital inflows would be reduced.

By late 1987, the turnaround in the current account deficit had still not materialized. The deficit was running at an annual rate of about $170 billion and net foreign debt was heading for $400 billion by year-end. In September 1987, the International Monetary Fund (IMF) predicted that without major changes in economic policies, the U.S. current account deficit would remain around $150 billion through 1991.[7] The IMF was skeptical that, under existing policies and exchange rates, the major economies would be able to reduce their current account balances to "sustainable levels."

International bodies such as the IMF, the Organisation for Economic Co-operation and Development, and the Bank for International Settlements have called for improved coordination of

[7]International Monetary Fund, *World Economic Outlook: Revised Projections* (Washington, D.C.: IMF, October 1987). See also "Fund warns of medium-term U.S. deficit crunch," *Financial Times* (London), September 28, 1987, p. 3.

Figure 4
U.S. Dollar Exchange Rates for Canada, West Germany, and Japan, 1980–87



Source: *International Financial Statistics* (International Monetary Fund), various issues.

economic policies.[8] This would involve sizable reductions in the U.S. budget deficit, expansionary fiscal policies aimed at stimulating domestic demand in Japan and West Germany, and continued support of the Louvre Accord of February 1987 in which the major countries committed themselves to stabilize exchange rates "around current levels." The idea is to bring about reduced current account imbalances by encouraging faster demand growth in Japan and West Germany than in the United States and to allow the impact of the depreciation in the U.S. dollar since early 1985 to be felt.

[8]See Organisation for Economic Co-ordination and Development, *Economic Outlook* (June 1987); and Bank for International Settlements, *Fifty-Seventh Annual Report* (Basle, June 1987).

Is a Correction Required?

Is a major adjustment in the U.S. current account balance really required? On this question, U.S. economists can be divided into three groups:[9] those in the "do-nothing" group argue that the U.S. trade deficit is not a serious economic problem requiring policy attention; those in the "mainstream macro" group believe that the U.S. trade deficit is purely a macroeconomic problem requiring a macroeconomic solution, the key ingredient of which would be a large cut in the U.S. budget deficit; and those in the "eclectic" group believe that the U.S. trade deficit, in addition to reflecting macroeconomic imbalances, is a symptom of poor productivity performance and requires increased policy emphasis on education and training, research and development, and capital investment.

The "do-nothing" group. Those who say that the U.S. current account deficit is not really a problem argue that the market knows better than government policymakers what the deficit should be and what is sustainable.[10] Some in this group point out that the depreciation of the U.S. dollar already is significant and that the trade deficit will decline in due course. Others argue that the trade deficit is just a reflection of the increase in foreign demand for U.S. financial assets that has occurred as world financial markets have been deregulated. Still others argue that the United States' foreign debt is not a problem because it is denominated in U.S. dollars and can be liquidated by a shift to inflationary policies.

The problem is that if one accepts these arguments and the "do-nothing" policy prescription, one must believe that markets — in particular, international asset markets — will sort things out without major disruptions that could lead either to recession or to a return to double-digit inflation. This argument has been greatly

---

[9]This discussion is based on a Symposium on Trade Protection conducted by the Brookings Institution. In particular, it draws on Rudiger Dornbusch, "External Balance Correction: Depreciation or Protection," and Gary Hufbauer, "Comments and Discussion," in *Brookings Papers on Economic Activity* 1 (1987): 249–269, 337–345. For a non-U.S. perspective on this issue, see Richard G. Lipsey and Murray G. Smith, *Global Imbalances and U.S. Policy Responses: A Canadian Perspective*, CAC 55 (Toronto; Washington, D.C.: Canadian-American Committee, 1987).

[10]Economists in this group include Herbert Stein and Franco Modigliani. See, for example, Stein, "Leave the Trade Deficit Alone," *Wall Street Journal*, March 11, 1987; idem, "A Primer on the Other Deficit," *AEI Economist* (March 1987); and Modigliani, "In the Shadow of the Budget Deficit," *New York Times*, March 1, 1987.

weakened by the stock market correction and the subsequent turmoil in world currency markets.

The "mainstream macro" group. Most mainstream economists argue that the U.S. current account deficit is a purely macroeconomic phenomenon.[11] They generally agree that a mix of tight monetary policy and loose fiscal policy early in the Reagan administration's term created high domestic demand growth, high real interest rates, and an overvalued U.S. dollar, which, in turn, led to a rising current account deficit. At the end of the 1981–82 recession, this policy mix shifted to a more accommodative monetary policy and increasing budget deficits, which created stronger growth in the United States than in Europe or Japan and further added to the United States' external deficit. The "mainstream macro" group argues that the appropriate policy prescription consists of three elements: U.S. deficit reduction, some further U.S. dollar depreciation, and more rapid growth in Europe and Japan. These economists undoubtedly are right in that their prescribed changes in macro policies would reduce the current account deficit. But based on the experience of the past three years, one can have little confidence that governments will actually make the necessary policy changes. Even if they did, there is no guarantee that by themselves these policies will preserve U.S. living standards, either in absolute terms or relative to those of other countries.

The "eclectic" group. Those economists who argue that microeconomic and structural problems also contribute to the U.S. trade deficit surely have a point.[12] They maintain that the productivity, innovativeness, and dynamism of the U.S. economy will play a major role in determining whether U.S. living standards are higher or lower after the eventual elimination of the U.S. current account deficit. Thus, this group's prescription includes increased policy attention

[11]Economists in this group include Rudiger Dornbusch, C. Fred Bergsten, Martin Feldstein, and Stephen Marris. See, for example, the Bergsten, Marris, and Dornbusch references cited in notes 3, 5, and 9 in this chapter; and Feldstein, "Correcting the Trade Deficit," *Foreign Affairs* 65 (Spring 1987): 795–806.

[12]Economists in this group include Robert Crandall, Robert Lawrence, and Paul Krugman. See, for example, Crandall, "The Effects of U.S. Trade Protection for Autos and Steel"; Robert Lawrence and Robert Litan, "The Protectionist Prescription: Errors in Diagnosis and Cure"; and Paul Krugman and Richard Baldwin, "The Persistence of the U.S. Trade Deficit," all in *Brookings Papers on Economic Activity* 1 (1987).

to facilitating adjustment in declining industries and to improving the quality of U.S. capital and human resources through increased investment and better education, training, and research.

A correction in the U.S. current account deficit does appear to be necessary to curtail the buildup of U.S. foreign indebtedness. It is too early to tell, however, what mechanism will bring this correction about. What became clear in 1987 was that if solutions are not found through more compatible macroeconomic policies in the industrialized countries, they may have to occur through disruptive changes in international markets.

October 19 and After

Until October 1987, world stock markets, led by New York, reflected little concern about the growing global economic imbalances. The Dow Jones Industrial Average increased from 1,912 at the end of December 1986 to 2,722 in August 1987, a gain of 42 percent.

What is perhaps least well explained about the behavior of stock markets in 1987 is not why they declined so sharply in October but why they rose by so much in the preceding nine months. There was little in the way of economic fundamentals to support such a gain. Economic growth in the industrial countries was proceeding at a respectable but unspectacular rate. Inflation and interest rates were, if anything, flashing bearish signals, particularly in the United States, where consumer price inflation had risen to 4.3 percent from 1.3 percent at the end of 1986 and where the prime interest rate had jumped to 9.2 percent from 7.5 percent.

Markets continued to rise in spite of these developments, investors apparently feeling that solutions would somehow be patched together through 1988 when a change in the U.S. administration might break the policy gridlock. This view became increasingly tenuous in the autumn of 1987.

There was little indication that the major industrial countries were moving toward more compatible macroeconomic policies. The U.S. Congressional Budget Office projected that, rather than falling, the U.S. budget deficit would *rise* to $192 billion in 1989 from $157 billion in 1987.[13] Statistics on the U.S. trade balance showed

[13]United States, Congress, Congressional Budget Office, *The Economic and Budget Outlook: An Update* (Washington, D.C., August 1987).

a deterioration in August and then remained unexpectedly high in September. As the U.S. dollar continued to come under selling pressure, forcing foreign central banks to become the primary source of capital inflows to the United States, open disagreement broke out between the United States and West Germany over interest rate policies.

These events proved too much for nervous world stock markets. Over four trading days ending on October 19, they underwent a massive correction that reflected their recognition that global imbalances were not turning around and that the necessary changes in economic policy would create difficult adjustments in the United States and world economies.[14] In New York, the Dow Jones index dropped almost 800 points — on top of the 200 points it had lost since August, this represented a drop of 32 percent. At the end of October, the Dow Jones was about 50 points, or 2 percent, below the level at which it had opened the year.

After the stock market fall, the key question facing the industrial countries was how to bring about a reduction in current account imbalances without a U.S.-led recession. Financial leaders, economists, and congressional leaders unanimously called for significant cuts in the U.S. federal budget deficit as a sign of U.S. leadership in tackling the imbalances. The Gramm-Rudman deficit-reduction act mandated a $23 billion cut, but many observers argued that a larger cut was needed to restore confidence in financial markets.

The Budget Compromise

In the event, the budget "summit" between the Reagan administration and congressional leaders was disappointing. The proposed compromise package of spending restraints and tax increases was billed as a $30 billion cut in the projected fiscal year 1988 deficit and a $46 billion cut in the following year. Careful analysis indicates, however, that the actual lasting cuts to the deficit will likely be smaller. For example, the proposed sale of $5 billion in suspect government assets, the promise of collecting an additional $1.6 billion in taxes through tougher enforcement, and other ques-

[14]For a similar view, see "Global growth and adjustment at risk," *World Financial Markets* (Morgan Guaranty Trust Company of New York), September/October 1987, pp. 1–2.

tionable items suggest that the budget compromise may actually cut less from the deficit than would have automatic Gramm-Rudman cuts.

The real issue is not whether the actual cut in the U.S. deficit is $30 billion, as proposed after the budget summit, or $23 billion, as mandated under Gramm-Rudman. In the $4.5 trillion U.S. economy, the difference is trivial. What is at issue is whether the United States can assume a leadership role in reducing global imbalances. The sharp drop in the U.S. dollar on foreign exchange markets in the weeks following the budget compromise represented a clear vote of nonconfidence on the part of international financial markets.

The Coming Correction

With or without U.S. leadership, global imbalances and the U.S. current account deficit will have to be corrected over the next several years. The buildup of U.S. foreign indebtedness is simply not sustainable. Just as the U.S. trade deficit's widening has wreaked major changes on the world economy, its narrowing will do the same.

Even if one assumes a steady reduction of $25 billion per year in the current account deficit, as in the correction scenario shown in Figure 3, the net foreign debt of the United States will reach $1 trillion by the early 1990s. The traditional U.S. surplus in its foreign investment income balance turned to a deficit in late 1987. It is set to worsen rapidly in 1988 and thereafter as the rapidly growing U.S. net foreign debt needs to be serviced. In order to service the burgeoning debt and at the same time to reduce the overall current account deficit, the U.S. balance on merchandise and traded services must make a sharp U-turn. It is possible, for example, that in the early 1990s, when the U.S. foreign debt reaches $1 trillion, the net investment income deficit will reach $30 billion per year.[15] In order for the United States to cut its overall current account deficit in half, to $80 billion, the balance on merchandise and traded services will have to improve from a deficit of over $180 billion in 1987 to just $50 billion within about five years.

[15]The figure for the projected net investment income deficit may appear to be a small percentage of the projected net foreign debt. The main reason is that the income from foreign investments is not all repatriated as it is earned. Indeed, most of the income is reinvested and does not show up in the balance of payments. To add further perspective, it was not until the third quarter of 1987, when U.S. net foreign indebtedness was around $350 billion, that the U.S. net investment income balance finally turned to a deficit.

Table 1
Contributions to Growth of Real National Income per capita, 1980–87
(percentage change at annual rates)

	1980–85	1986	1987[a]
Increase in real income per capita	*1.2%*	*1.3%*	*2.4%*
Source of change in real income per capita			
Terms of trade	−0.4	−0.9	0.3
Net foreign investment income	−0.1	−0.3	0.2
Productivity	1.7	0.5	0.7
Employment ratio	−0.7	1.0	0.5
Labor force participation	0.4	0.7	0.7
Ratio of labor force population to total population	0.3	0.2	0.1

[a]Based on the first nine months of 1987.

Source: C.D. Howe Institute, based on data from *Bank of Canada Review*, various issues.

investment picked up smartly for the first time since the 1981–82 recession.

Booming demand and higher federal and provincial government sales taxes pushed inflation higher, but the increase in inflation, based on the Consumer Price Index, was moderate — to 4.5 percent from 4.1 percent in 1986. Job growth accelerated — approximately 330,000 jobs were added during the year — and the unemployment rate dropped more than a full percentage point to just above 8 percent by year-end.

Strengthening commodity prices helped spread the expansion across all regions of the country in 1987. Coming after the collapse of world oil and grain prices that had exacerbated regional divergences in economic growth in 1986, this was a welcome development.

Why, after four years of moderately paced recovery, did the Canadian economy boom in 1987? In the past year, real national income per person increased by 2.4 percent, about twice the average rate of the preceding six years. Table 1 breaks down the growth of real

income per capita in the 1980s into six components.[2] In the first half of the 1980s, real income growth was reduced by a large drop in the share of the labor force at work and by a steady deterioration in Canada's terms of trade — the ratio of the price of what Canada produces to the price of what it consumes. The terms of trade deteriorated as the prices of Canada's raw-materials-based exports dropped in world markets. In 1986, although improving labor force participation, employment, and productivity boosted real income growth, much of the improvement was offset by a further sharp deterioration in the terms of trade that resulted from the collapse of petroleum and grain prices in world markets.

The downward trend in the terms of trade finally reversed in 1987, the shift being entirely responsible for the improvement in per capita real income growth. The return of a modicum of discipline within the Organization of Petroleum Exporting Countries restored crude oil prices to the U.S.$18–20 barrel range for most of the year. Prices for forest products and minerals also improved. After-tax corporate profits increased at a 25 percent rate and retained earnings at almost a 50 percent rate. Improved business cash flow fueled capital spending and job creation.

At mid-year, Canadian forecasters, perhaps caught up in the boom themselves, were virtually unanimous in predicting a continuation of the strong economy through 1988.[3] This "clear sailing" consensus was shattered on October 19, when world stock markets plummeted. The international factors that contributed to the decline are discussed later in this chapter. Suffice it to say that the economy remains highly vulnerable to turbulence in international financial markets.

The stock market decline has greatly increased uncertainty about whether the economic expansion will continue for a sixth year in 1988. In any event, the booming conditions of 1987 would not have been sustainable, with or without a stock market correction. Since October 19, the question has been the extent to which a recession is likely and the degree of Canada's vulnerability.

---

[2]This breakdown is suggested in John F. Helliwell, Mary E. MacGregor, and Tim Padmore, "Economic Growth and Productivity in Canada, 1955–90," in John Sargent, ed., *Economic Growth: Prospects and Determinants*, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada no. 22 (Toronto: University of Toronto Press, 1985), pp. 27–64.

[3]See James G. Frank, "Sixth Year of Expansion in the Cards," *Canadian Business Review*, Autumn 1987, pp. 4–7.

Achieving such a $25 billion per year improvement in net exports will require a significant reconfiguration of U.S. production and consumption. Domestic production in the United States will have to grow 1–2 percentage points faster than consumption — reversing the pattern of the mid-1980s. As Fred Bergsten has pointed out,

> this would be a huge adjustment, even for an economy as large as America's. The shift of resources into export and import-competing products will amount to between four and five percent of the total U.S. GNP, or about two thirds of the total defense budget. It is a far larger adjustment than that required to meet either oil shock of the 1970s.[16]

The need for this correction is not in doubt. An underlying question, however, is whether the adjustment will occur in an environment of expanding world trade or in one of growing protectionism, stagnating world trade, and prolonged recession. A second question is how the United States' largest trading partners — Canada, Japan, and Europe — will be affected.

Implications for the United States' Trading Partners

What, then, are the implications for the United States' major trading partners, and for Canada in particular? Achieving the necessary turnaround in the overall U.S. merchandise and traded services account will require major reversals in U.S. regional and sectoral trade deficits. In 1986, the U.S. trade balance was in a deficit position with every major geographical area of the world — Japan, above all — as shown in Table 2. As the final column of the table shows, however, since 1980 the U.S. trade balance has deteriorated almost as much with other Asian countries and the European Community as it has with Japan. Although the United States' largest bilateral trading relationship is with Canada, its deficit with Canada increased less than with other industrial areas.

The U.S. trade balance by major commodity group, also presented in Table 2, indicates that the United States had large deficits in its trade in consumer goods, automotive products, and industrial materials, while its trade balances in capital goods, food products,

---

[16]Bergsten, "Economic Imbalances and World Politics," 781.

Table 2
U.S. Merchandise Trade Balance by Area and Commodity, 1986
(U.S.$ billions)

Area	Exports	Imports	Balance	Change since 1980
Canada	$ 54.2	$ 70.3	$ −16.1	$ −14.8
European Community	52.2	74.5	−22.3	−39.7
Japan	26.4	81.0	−54.6	−44.2
OPEC	10.5	19.0	−8.5	29.7
Other Asia	29.7	63.1	−33.4	−53.3
Rest of World	48.8	61.6	−12.8	
Total	*221.8*	*369.5*	*−147.8*	*−122.3*

Commodity group	Exports	Imports	Balance	Change since 1980
Food, feed, beverages	$ 22.6	$ 24.0	$ −1.4	$ −19.0
Industrial materials	63.4	103.1	−39.7	21.7
Capital goods	79.2	75.7	3.5	−39.5
Automotive — Total	23.9	78.0	−54.1	−43.7
— Canada	18.1	24.8	−6.7	−8.3
— Other	5.8	53.3	−47.5	−34.5
Consumer goods	14.5	74.0	−59.5	−37.2
Other	18.2	10.6	7.6	1.9
Total	*221.8*	*369.5*	*−147.8*	*−122.3*

Source: *Survey of Current Business* (U.S. Department of Commerce, Bureau of Economic Analysis), various issues.

and other items were much more favorable. When one examines changes since 1980, however, it is clear that the deterioration in the U.S. trade balance has been concentrated in automotive products, capital goods, consumer goods, and food products. The deficit on industrial materials has declined due largely to the fall in oil prices in 1986.

To move toward a more manageable current account deficit of $50–80 billion by the early 1990s — a level that would be consistent with a stable ratio of external debt to GDP — the United States will have to improve its trade deficit by $130 billion over the next five years. It is unlikely that much of this improvement will come in the area of food products; oversupplies in world agricultural

markets will depress both prices and volumes of U.S. exports. And any improvement in U.S. exports in nonoil industrial materials is likely to be offset by increased oil imports in future. This implies that most of the turnaround in the U.S. trade deficit will have to be concentrated in capital goods, automotive products, and consumer goods — that is, in the manufacturing sector.

The United States, therefore, must find markets in both industrialized and developing countries for its manufactured exports and/or find ways of reducing its imports from Canada, Japan, the European Community, and the newly industrializing countries of Asia.

Imports of automotive products from Asia may be replaced by the output of new Asian auto plants located in North America. This trend is already under way, powered by the appreciation of the Japanese yen and Asian concerns about U.S. protectionism. Canada and the European Community also may come under pressure to reduce their automotive trade surpluses with the United States.

The United States will require major improvements in its merchandise trade in manufactured capital and consumer goods. The most positive way for this to occur would be through a major expansion of U.S. manufactured exports to developing countries, both to accelerate economic development and to meet growing consumer demand. Market-opening measures and stronger economic growth in Europe and Japan, and free trade with Canada, could also aid in the adjustment.

If these positive developments are not forthcoming, there is considerable risk that correction of the U.S. trade balance will occur through some combination of increased U.S. protectionism and sharply reduced U.S. domestic spending.

This, of course, is the great risk posed by global current account imbalances. A major outbreak of U.S. restrictions on imports would invite retaliation from the United States' trading partners and could throw the world economy into a serious recession. What is worse, from a Canadian perspective, is that, unless it is exempted from U.S. protectionism, Canada would stand to be hit harder than most countries by a forced adjustment in the U.S. trade balance. As a percentage of GNP, Canada's exports to the United States are higher than for any other U.S. trading partner. Across-the-board import restraints and/or a sharp drop in U.S. spending would deal a severe blow to the Canadian economy.

The failure of the budget "summit" to achieve a sizable reduction in the U.S. budget deficit is not a good omen. The inability of the United States to adjust social security entitlements, defense spending, or taxes in a meaningful way has created a policy gridlock in that country. The question is whether the world economy can wait for a U.S. election to break the gridlock.

Looking Ahead to 1988

The year ahead is likely to be one of considerable economic and political volatility. Global interdependence and the associated rapid transmission of financial and economic impulses throughout the world economy is a fact of life that policymakers must deal with daily. The integration of global markets has the positive effect of increasing their depth and resiliency. From the perspective of individual countries, however, interdependence means that policymakers cannot afford to ignore the potential responses to their actions by participants in international financial markets or partners in international trade.

International markets and Canada's trading partners will be watching carefully in 1988 to see if the policy agenda the federal government has devised over the past three years will be successfully implemented. From a Canadian perspective, the best defense against a potentially threatening global environment is a good offense — namely, sound domestic policies and private-sector adjustments that enhance the competitiveness, flexibility, and macroeconomic stability of the Canadian economy. The chapters that follow focus on the elements of a good offense.

2

New Rules of the Game: Free Trade and Tax Reform

It is just possible that the world could find — to its surprise — that it looks to Canada in the next decade or two for a vision of how industrial society will develop.

The Economist
February 15, 1986

Three years into its electoral mandate, the federal government made good on two important policy objectives in 1987: it introduced proposals for comprehensive tax reform, and it reached a tentative agreement with the United States on forming a free trade area. Both are of great significance for Canada. Inevitably, some proponents were disappointed that these steps did not meet all of their expectations. Nevertheless, both offer the potential of enhanced economic growth and improved living standards for Canadians.[1] For this potential to be realized, however, significant adjustments will be required in the Canadian economy. This chapter examines the challenges Canadians face in adjusting positively to the emerging tax and trade policy environment.

First, we characterize the emerging environment as one that is intended to achieve increased competition, a more level playing field that reduces special treatment of particular industries, and a more stable, predictable policy environment.

Next, we examine the findings of the most authoritative studies undertaken on the impacts of free trade and tax reform. Taken together, these studies suggest that considerable rationalization of Canadian industry will be required to improve efficiency and international competitiveness. If these adjustments take place, output

[1] For assessments of the tax reform and trade proposals, see Edward A. Carmichael, ed., *Tax Reform: Perspectives on the White Paper*, Policy Study no. 4 (Toronto: C.D. Howe Institute, 1988); and Richard G. Lipsey, *The Canada-U.S. Free Trade Agreement and the Great Canadian Trade Debate*, Trade Monitor no. 1 (Toronto: C.D. Howe Institute, November 1987). Future issues of *Trade Monitor* will deal with the key issues raised by the free trade agreement.

will expand in virtually all broadly defined industry groups, and economy-wide employment and real incomes will increase. These results imply that, if properly and fully implemented, tax reform and free trade are capable of providing a significant boost to the economic well-being of Canadians in the 1990s.

Finally, we conclude the chapter by noting that, while the progress in 1987 on free trade and tax reform was encouraging, important unfinished business remains.

Understanding the New Environment

The tax reform proposals and the Canada-U.S. Free Trade Agreement signal a major shift in two of the most fundamental economic policies that the federal government has at its disposal. Trade and tax policies define the basic rules of the economic game in all industrial countries. Trade policies influence the terms on which Canadian producers compete with imports as well as the scope and security of access of Canadian exporters to foreign markets. Tax policies influence the allocation of investment and employment among industries and the distribution of the rewards of economic activity.

The tax reform and free trade proposals of 1987 are grounded in principles that the federal government developed early in its term of office. In a May 1985 budget paper, it established a basic principle to be incorporated in its tax reforms affecting business:

> The corporate tax system should interfere as little as possible with the market signals that form the basis of business decisions. Activity should be driven by the soundness of the underlying business opportunities, not merely the ability to achieve a favourable tax result....As opposed to a system involving high rates of write-offs and high tax rates, incentives based on lower tax rates reward success, rather than effort.[2]

In announcing its intention to enter into free trade negotiations with the United States in September 1985, the government outlined four basic objectives:

---

[2]Department of Finance, *The Corporate Income Tax System: A Direction for Change* (Ottawa, May 1985), pp. 2-3.

- security of access to the U.S. market through a reduction in risks inherent in restrictive trade measures;
- expanded access and realization of economies of scale for Canadian industry;
- a stable continental trading system providing for an "orderly transition" toward a more internationally competitive economy; and
- a more ordered and "predictable" system for managing trade and resolving disputes.[3]

The government's clear intent in pursuing these tax and trade objectives was to establish an economic environment that is less influenced by government intervention and therefore more *neutral*, more *competitive*, and more *predictable*.

Neutrality would be enhanced by reducing tax preferences and trade barriers that discriminate in favor of particular industries. *Competition* would be enhanced by lowering barriers to imported goods and services. *Predictability* would be enhanced by tax reforms that broaden tax bases and thereby reduce the need for continual fine-tuning of the tax system, by restricting the ability of Canada and the United States to resort to protectionist trade policies, and by developing a more reliable system for settling trade disputes between the two countries.

While there can be little argument that such changes will have a long-term beneficial impact on the economy, getting "from here to there" will involve considerable restructuring of economic activity. This will involve the more rapid expansion of some activities and industries than would have been the case without the policy changes, while others will expand less rapidly or even contract. Thus, both free trade and tax reform will require adjustments in the scale, scope, and organization of affected industries. A key question that has not yet been studied is the *combined* impact — both macroeconomic and interindustry — of the proposed changes to trade and tax policies.

A Brief Digression on Methodology

Before assessing the estimated impact of free trade and tax reform, it is essential to consider how these estimates are arrived at.

---

[3]Department of External Affairs, *Communiqué*, September 26, 1985.

When most people think about the impact that free trade or tax reform will have on them, they think of the direct effect of such changes on jobs in the industry they work in and, to a lesser extent, on the prices that they pay for the things they consume. In the language of economists, these people are attempting a "partial equilibrium" estimate of the impact of policy changes. They are not evaluating the indirect, economy-wide impact of these changes.

In the case of a change in a single tax provision (such as the treatment of capital cost allowances) or a single trade policy (such as a restriction on Japanese car imports), evaluating only the direct effects of the change may be reasonable. In the case of sweeping changes in tariffs and nontariff barriers or in the overall tax system, however, looking only at direct effects of the changes can be highly misleading and inaccurate. A more accurate estimate of the overall impact — and the interindustry impact — of such changes requires what economists call a "general equilibrium" analysis that takes into account all direct and indirect effects of the proposed changes.[4]

Consider the impact of the free trade agreement with the United States, which will eliminate almost all tariff and nontariff barriers to trade between the two countries. This is a major change that will affect the prices and costs of production of virtually all goods and services in Canada. There will be important impacts on economy-wide wages, returns on capital, and land rents. These will translate into significant changes in real incomes and interindustry shifts in the allocation of resources. It is inaccurate, therefore, to estimate the impact of comprehensive free trade on a particular industry by looking only at the direct effect of reducing trade barriers in that industry.

Consider, for example, the impact on a relatively highly protected industry such as clothing. A partial equilibrium assessment of the impact of free trade would focus on the direct effect on the price of clothing, and the resulting reduction in the viability of relatively high-cost Canadian clothing manufacturers. Apart from some areas

---

[4]For a more detailed discussion of the general equilibrium approach, see Richard G. Harris with David Cox, *Trade, Industrial Policy, and Canadian Manufacturing*, Ontario Economic Council Research Studies no. 31 (Toronto: Ontario Economic Council, 1983); and John Whalley and Irene Trela, *Regional Aspects of Confederation*, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada no. 68 (Toronto: University of Toronto Press, 1986).

in which Canadian firms have already established a competitive advantage, a partial equilibrium analysis likely would consider the clothing industry to be a loser in the free trade deal.

General equilibrium estimates of the impact of the free trade agreement on the clothing industry produce a different result, for several reasons. First, this approach takes into account the impact of free trade on real wages and returns to capital in different industries. It allows evidence on how production costs vary with the scale of operations and industry rationalization to influence the demand for labor and capital in various industries. In general, when trade barriers are reduced, profitability rises in export-oriented industries. This attracts labor and capital into these industries, bidding up economy-wide wages in the process. As Richard Harris has pointed out, these effects of changing labor and capital demands and prices

> on capital-intensive/decreasing-cost industries versus labor-intensive/increasing cost-industries are extremely important. Partial equilibrium analysis working with constant [labor and capital] prices would probably seriously underestimate...the probable gains.[5]

Second, the general equilibrium approach takes into account the increase in real income and aggregate demand that would accompany a reduction of trade barriers between Canada and the United States. Higher real incomes in both countries would lead to increased demand for clothing, an indirect benefit of free trade to the clothing industry.

Third, the general equilibrium approach can take account of each industry's potential to increase productivity by rationalizing production and selling to the combined Canadian-U.S. market rather than to just the relatively small Canadian market. By achieving such increases in productivity and competitiveness, the clothing industry, to continue our example, has the potential to specialize and become more competitive. When these important indirect effects are taken into account, general equilibrium studies indicate that the clothing industry would experience an improvement in productivity and an expansion of output and employment under free trade.

---

[5]Harris and Cox, *Trade, Industrial Policy, and Canadian Manufacturing*, p. 32.

Another advantage of general equilibrium studies is that they show the potential benefits to "nontraded" industries from free trade. An example is the construction industry. Although construction services do not enter into Canada's trade with the United States in a major way, the construction industry shows up in general equilibrium studies as one of the major winners from free trade. The reason is that, under free trade, resources will be shifted toward Canada's exporting industries — forest products, mining and metal products, petroleum products, and transportation equipment — which tend to be relatively capital intensive. Thus, the shift toward these industries will result in a substantial increase in nonresidential construction.

To summarize this methodological digression, one should note that the partial equilibrium assessments of the impact of major changes such as free trade or tax reform are often quite misleading. Yet it is this type of direct impact estimate that predominates in most media accounts of the impact of such changes on particular industries or on the economy as a whole. It is somewhat ironic that while Canadian economists such as Richard Harris of Queen's University and John Whalley of the University of Western Ontario are internationally known for their general equilibrium analyses of trade liberalization and tax reform, their ground-breaking studies have received little attention in public debates over these issues in Canada. In our view, however, such studies provide the best guide to understanding the impact of these fundamental structural policy changes on the Canadian economy. In the remainder of this chapter, we summarize what general equilibrium analyses tell us about the likely impact of free trade and tax reform.

Overall Economic Impact

In their 1985 study of Canada's trade options, C.D. Howe Institute economists Richard Lipsey and Murray Smith concluded that, of the available options, bilateral free trade with the United States promised the greatest opportunity: "No other option seems to us to offer anything approaching the gains [from Canada-U.S. free trade]."[6] At the time of their writing, available studies estimated

[6]Richard G. Lipsey and Murray G. Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation no. 27 (Toronto: C.D. Howe Institute, 1985), p. 81.

Table 3
Potential Macroeconomic Impact of Free Trade and Tax Reform
(percentage change)

	Free trade[a]	Tax reform	
		First stage[b]	Second stage[c]
Real GNE	3.3%	0.3%	1.5%
Personal consumption	4.1	n.a.	n.a.
Business investment	7.0	n.a.	4.0
Consumer prices	−5.7	0.3	n.a.
Employment	2.6	0.2	n.a.
Productivity	0.7	0.1	n.a.
Real wage rate	3.0	n.a.	n.a.
Real disposable income	3.1	n.a.	n.a.

n.a.: not available.

Sources: *(a)* S. Magun, S. Rao, and B. Lodh, *Impact of Canada-U.S. Free Trade on the Canadian Economy*, Economic Council of Canada Discussion Paper no. 331 (Ottawa: Economic Council of Canada, August 1987); *(b)* Pierre Fortin, "Tax Reform and the Macroeconomy: Jobs, Inflation and Growth" (Paper presented at a Conference on the Economic Impacts of Tax Reform, Toronto, Canadian Tax Foundation, October 1987), Mimeo.; *(c)* Department of Finance, *Economic and Fiscal Outlook* (Ottawa, June 1987).

that the gain to Canada from free trade with the United States was in the range of 1.3 to 8.6 percent of Canada's GNP. Studies of the potential gains from tax reform are less numerous, but those that do exist suggest that sizable gains — between 1 and 2 percent of GNP — are possible from removing the wide range of distortions to the allocation of capital that have accumulated in Canada's tax system. Table 3 presents estimates of the potential macroeconomic impacts of Canada-U.S. free trade and tax reform. The impact of tax reform is divided into that of the first stage — personal and corporate tax reform — and that of the second stage — sales tax reform.

The results in Table 3 are representative estimates based on a survey and synthesis of available quantitative studies. Representative estimates of the impact of free trade are based on an analysis carried out by the Economic Council of Canada.[7] The Council's study, carried out before the preliminary agreement was signed,

[7]Sunder Magun, Someshwar Rao, and Bimal Lodh, *Impact of Canada-U.S. Free Trade on the Canadian Economy*, Economic Council of Canada Discussion Paper no. 331 (Ottawa: Economic Council of Canada, August 1987).

contains assumptions about the details of the trade agreement that are broadly in line with the actual agreement and assumptions about the scope for increased productivity in Canadian industry that are cautiously conservative. Yet even with conservative assumptions, the potential benefits of free trade stand out clearly. Reduction of tariff and nontariff barriers between Canada and the United States would reduce consumer prices by almost 6 percent and raise real wages and real disposable incomes by about 3 percent. Real consumer spending and business investment would increase by 4 percent and 7 percent respectively. In 1987 dollars, this translates into a gain in consumer spending of $500 for each Canadian, or $2,000 for a family of four in perpetuity.

The potential macroeconomic impact of tax reform — particularly the first-stage reforms — is more modest. The estimates in Table 3 are based on analyses carried out by economist Pierre Fortin and by the Department of Finance.[8] These studies estimate that the first-stage reforms — to personal and corporate taxes — will have a positive impact in the short term on disposable income and consumer spending and in the longer term on incentives to work and on the productivity of capital arising from fewer tax distortions influencing employment and investment decisions. The second stage of tax reform — which would replace the manufacturers' sales tax (MST) with a multistage sales tax — promises a more substantial gain of 1.5 percent in real gross national expenditure. By reducing the cost of business inputs and removing biases in the sales tax that favor imports and raise of cost of Canadian exports, the sales tax reform would also enhance the competitiveness of important segments of Canadian business and help improve Canada's current account balance.

Taken together, the potential macroeconomic benefits of free trade and tax reform are substantial. Real GNP per capita could be increased by about 5 percent, or $1,000 in 1987 dollars, by the time the full impact of these policy changes is felt in the 1990s. To put this gain in perspective, it is slightly greater than the increase in real GNP per capita generated by economic growth over the five-year period from 1980 to 1985. Based on current projections, the gain would increase the rate of growth in real per capita income by 50 percent in the first five years of the 1990s.

[8]Results are reported in Department of Finance, *Tax Reform 1987: Economic and Fiscal Outlook* (Ottawa, June 1987).

It is important to stress, however, that these are estimates of the *potential* gains from the trade and tax initiatives. The actual gains could be reduced by several factors, including:

- an increase in U.S. administered protection;
- failure to proceed with sales tax reform; and
- inadequate adjustment and restructuring in the private sector.

The benefits from the free trade agreement will be reduced if the aggressive use of countervail, antidumping, and safeguard actions by industry groups in the United States is not curtailed. This is why those who favor free trade have stressed the importance of obtaining new trade rules and an effective dispute settlement body to act as an impartial referee. Their concerns were further heightened in 1987 by the prospect of passage of the U.S. omnibus trade bill, which contains numerous measures that would make it easier for industry groups in the United States to obtain favorable rulings in countervail cases and that would reduce the discretion of the president to limit penalties on imports.[9]

The benefits from tax reform will be reduced if the second stage of reform — particularly the replacement of the MST with a broadly based multistage sales tax — is not implemented. The benefits of sales tax reform derive from reduced taxation of business inputs, more neutral treatment of industries, elimination of the sales tax burden on exports, and an end to the favorable treatment of imports under the MST.[10] The need for these changes in the sales tax is heightened by the prospect of free trade. The proposed reform would provide a competitive advantage to Canadian firms as they adjust to the elimination of tariff and nontariff barriers.

Finally, the benefits from both free trade and tax reform will be reduced if the private sector is slow to adjust to the new environment. The need to adjust is amplified by the fact that Canada and the United States have industrial structures that are competitive

---

[9]See Murray G. Smith, "Redefining Subsidies in U.S. Countervailing Duty Law: New Hazards for Canada," *International Economic Issues* (Institute for Research on Public Policy), September 1987, pp. 17-21.

[10]For a detailed treatment of the need for sales tax reform, see John Bossons, "Sales Tax Reform: The Postponed Part of the Package," in Carmichael, ed., *Tax Reform: Perspectives on the White Paper.*

with each other — that is, they produce a roughly similar range of industrial products, for people with roughly similar incomes and tastes.

Victoria Curzon Price, a Geneva-based expert on free trade arrangements in Europe, correctly points out that free trade between economies with competitive industrial structures produces greater economic benefits than free trade between complementary economies:

> The...fact to remember is that if freeing trade produces no pain, it probably produces no gains either, since the gains emerge from the compulsory reallocation of resources. In other words, the gains are proportional to the cost of adjustment....Moreover, there is every reason to believe that the 'pain' is much exaggerated.
>
> What the story of European economic integration tells us is that one can have a union of competitive economies with much less 'blood on the floor' than is commonly thought.[11]

The European experience is, therefore, encouraging. Nevertheless, those firms and individuals that adapt quickly and effectively to the freer trade and more neutral tax environment will benefit most. It is impossible to say precisely in advance which firms and industries will be the major winners and losers. Much will depend on the state of the North American economy and world markets for particular goods and services. It is widely recognized that the adjustment to trade liberalization in Europe was made easier by the generally favorable economic climate of the day. As we pointed out in Chapter 1, however, the late 1980s and early 1990s likely will be a period of substantial adjustment in international trade as the U.S. trade balance turns around. From Canada's perspective, it would be greatly preferable if the adjustment to free trade with the United States and the larger adjustment in the U.S. trade balance could occur in the context of a favorable global economic climate. Again, as we indicated in Chapter 1, there is considerable risk that this will not be the case.

To summarize, the potential macroeconomic benefits of free trade and tax reform are substantial, enough to increase the growth rate

---

[11]Victoria Curzon Price, *Free Trade Areas, the European Experience: What Lessons for Canadian-U.S. Trade Liberalization?*, Observation no. 31 (Toronto: C.D. Howe Institute, 1987), p. 16.

of real income per capita by 50 percent in the first half of the 1990s, compared with current projections. These gains are not assured, however. To achieve them, Canada must see to it that the benefits of free trade are not thwarted by U.S.-administered protection, that the sales tax reform is implemented along with free trade, and that private-sector adjustment and restructuring is facilitated. We now turn to an assessment of the interindustry adjustments implied by free trade and tax reform.

Industry Impact

Understanding the impact of trade and tax policy changes on individual industries requires more than a simple thought experiment about what a lower tariff or quota, a higher tax rate, or a reduced tax deduction is likely to mean to a particular firm or industry. As we pointed out in the earlier discussion on methodology, comprehensive elimination of tariff and nontariff barriers and fundamental reform of the overall tax system will have significant economy-wide effects on the returns to particular business inputs — labor, capital, and land — as well as on the productivity and real income the economy generates. Understanding the impact of such changes on an individual industry, therefore, requires a complex, economy-wide analysis, rather than a simple assessment of the apparent direct impact.

In this section, we survey empirical general equilibrium studies of the impact of free trade and tax reform on major Canadian industries. Table 4 presents a summary of the results for 12 industry groups covering the entire private sector of the economy. The results represent the qualitative impact on industry output of particular trade and tax policy changes. Once again, this qualitative summary is based on quantitative estimates carried out by the Economic Council of Canada and by Richard Harris for Canada-U.S. free trade, and by the Department of Finance and John Whalley and Bob Hamilton for tax reform.[12] In the table, the impacts range from

[12]See Magun, Rao, and Lodh, *Impact of Canada-U.S. Free Trade on the Canadian Economy*; David Cox and Richard G. Harris, "A Quantitative Assessment of the Economic Impact on Canada of Sectoral Free Trade with the United States," *Canadian Journal of Economics* 19 (August 1986): 377–394; Department of Finance, *Tax Reform 1987: Economic and Fiscal Outlook*; and Bob Hamilton and John Whalley, "Efficiency and Distributional Effects of the Tax Reform Package," in *Proceedings of a Conference on the Economic Impacts of Tax Reform* (Toronto: Canadian Tax Foundation, forthcoming).

Table 4
Potential Impact of Free Trade and Tax Reform on Output, by Sector

	Free trade	Tax reform		Overall impact	
		First stage	Second stage	Free trade & first stage of tax reform	Free trade & both stages of tax reform
Agriculture, food, beverages, and tobacco products	..	..	..	..	..
Forest and wood products	+	−	+	..	+
Mining and metal products	++	−	+	+	++
Mineral fuels, petroleum, and coal products	++	−	+	+	++
Other nondurable manufacturing	−	−	++	−−	..
Transportation equipment	+	−	+	..	+
Other durable manufacturing	..	−	+	−	..
Construction	++	+	−	++	++
Transportation, communication, and other utilities	+	+	−	++	+
Trade	++	+	−	++	+
Finance, insurance, and real estate	++	−	..	+	+
Other services	+	+	−	++	+

Note: The symbol .. means that the net impact on the sector's output is undetermined.

Source: C.D. Howe Institute.

strongly positive, shown by the symbol ++, to strongly negative, shown by the symbol −−. The impact is shown for free trade, for the two stages of tax reform, and for the two policy changes combined.

The industry groupings reflect, for several industries, the integrated nature of economic activity in different sectors of the economy. For example, agriculture (that is, farm output) is grouped with food, beverage, and tobacco products — what is often referred to as the agrifood business. It incorporates all of the major stages of production, from the farm gate through industrial processing of the final product. It therefore includes both the primary and manufacturing components of the business. Other integrated industry groupings include forest and wood products, metal mining and products, and mineral fuels, petroleum, and coal products.

Manufacturing activities not included in the integrated groupings are divided into three groups: other nondurable manufacturing, transportation equipment, and other durable manufacturing.

Most of the popular discussion of free trade focuses on the industries contained in the first seven groups shown in the table. This is simply because these industries conduct the vast majority of Canada's international trade. Important as these industries are, however, it is worth remembering that they account directly for less than one-quarter of the jobs in Canada and about 30 percent of Canada's GNP.

The rest of the jobs and production are found in construction and in a range of business, personal, and community services industries. The impact of free trade and tax reform on these industries has received too little attention — probably because the direct effects seem unclear. It is in these sectors that general equilibrium analysis is particularly enlightening. As we shall see, the large majority of new jobs generated by free trade — over 80 percent of the total by one estimate — will be in the construction and services industries.

Resource-Based Industries

Agriculture, Food, Beverages, and Tobacco Products

The agrifood industry will experience a mixed impact from free trade and a neutral impact from tax reform. The trade agreement does not represent complete free trade in agriculture and food products. All bilateral tariffs eventually will be eliminated, but numerous quotas, supply management programs, and marketing boards will be retained. Tax reform has been designed to minimize the impact on agriculture and food — a tendency that will continue with the exemption of food from the proposed multistage sales tax.

The trade agreement will have several important direct effects on the agrifood industry and, given the diversity of agriculture, these will differ substantially across individual sectors of the agrifood industry. Canada will benefit from improved access to the U.S. market for key exports such as meat and livestock, grains and oilseeds, and potatoes. From the consumer's perspective, the agreement likely will mean a modest reduction in food prices. The agreement rules out a more substantial price benefit by retaining many quotas and

supply management programs, notably in the dairy and poultry industries. The fruit and vegetable industries will face considerably stiffer U.S. competition as Canadian tariffs are reduced and as discriminatory provincial liquor board markups and pricing policies are phased out. Canada can temporarily restore tariffs on fresh fruits and vegetables during the first 20 years of the agreement in the event of depressed price conditions. For the food-processing industry, free trade will improve access to the U.S. market, but there is concern that if quotas and marketing boards for several key agricultural products keep their prices higher in Canada than in the United States, Canadian food processors will have difficulty competing with their U.S. counterparts.

Tax reform will do little to alter the favored treatment of agriculture, which, after reform, will face the lowest corporate tax rate and most favorable capital gains taxation of any sector of the economy. This favorable treatment will continue if the federal government proceeds with sales tax reform. Strong political pressures already have led to an exemption from the sales tax, on the grounds that taxing food would hurt lower-income individuals and families. This is unfortunate, since a reform that includes food and provides an income-related sales tax credit would leave low-income individuals better off than a sales tax that exempts food.[13] By late 1987, however, the federal and provincial governments had already decided that they would not challenge the strongly entrenched public attitude against taxing food.

The net result of the trade and tax reforms on the agrifood industry will be mixed, but on the whole neutral to modestly positive. Output gains resulting from improved growth of real incomes, increased access to the U.S. market for some major agricultural exports, and continued favorable tax treatment will offset possible output losses in other agrifood sectors.

Forest Products, Metals, and Energy Industries

The resource-based industries (other than agriculture) will gain from free trade, lose from corporate tax reform, and gain from sales tax reform. As a group, these industries will benefit from the proposed changes, and the size of the gain can be larger if the federal

---

[13]See Bossons, "Sales Tax Reform."

government follows through with negotiation of improved trade laws and sales tax reform.

The main direct benefits of the free trade agreement will come from duty-free and more secure access to the U.S. market for Canadian resourced-based products. In the Tokyo Round of multilateral trade negotiations, an unfulfilled objective of the Canadian negotiators was to bring about significant reductions in tariffs in resource-based industries in order to encourage further processing of natural resources in Canada. Further processing has been discouraged in the past by foreign, including U.S., tariff escalation on natural resource products. Tariff escalation refers to a situation in which countries permit imports of unprocessed resources at zero or very low tariff rates, but impose escalating tariffs at each successive stage of processing. The result is that the effective protection on value added from processing is considerably higher than the nominal tariff rates indicate. By eliminating tariffs on bilateral trade, the agreement will eliminate tariff escalation for Canada's resource industries in their largest market.

The ultimate impact of free trade on the forest products industry will depend in part on the effectiveness of the new dispute settlement mechanism, as well as on future success in negotiating improvements in bilateral trade laws covering subsidies, countervail, and dumping. The industry was hit twice in 1986 — in cedar shakes and shingles and in softwood lumber — by the aggressive application of U.S. trade laws. The trade agreement will eliminate the duty imposed on shakes and shingles in 1991, but it does not affect the export tax that Canada was forced to impose on softwood lumber exports to the United States. In future, U.S. attacks on Canada's forest and wood products industries will be more difficult to sustain because the binational dispute panels will make trade law proceedings more objective and less subject to national political biases. Until some cases have been heard, however, it will be difficult to say how much more secure is Canada's access to the U.S. market. For the time being, however, the Canadian forest industry's view is that the new dispute settlement mechanism contained in the trade agreement is a considerable improvement over the status quo.[14]

---

[14]See the testimony of T.M. Apsey, President and Chief Executive Officer, Council of Forest Industries of B.C., to the House of Commons Standing Committee on External Affairs and International Trade, November 23, 1987. p. 54.

In the energy sector, Canada will benefit from more secure access to the U.S. market. There is considerable protectionist sentiment in the natural gas, electricity, and uranium industries in the United States, focused on energy imports from Canada. While tariffs are very low on energy trade, the United States has employed regulatory measures to reduce Canadian imports while Canadian regulatory authorities have applied various surplus and price tests that have had the effect of reducing Canadian exports. The agreement will contain or reduce these regulatory impediments to trade on both sides of the border, providing increased access for Canadian energy to the U.S. market.

For crude oil, the trade agreement means that possible future U.S. tariffs or surcharges on imported oil would not be applied to imports from Canada. For natural gas, any regulatory decisions U.S. agencies such as the Federal Energy Regulatory Commission take that Canada considers to be inappropriate will be subject to consultation and negotiations. For electricity, threatened restrictions on access to U.S. electric power distribution will not be applied. And for uranium, the U.S. embargo on imports of uranium from Canada will be lifted. One consequence of more secure access will be increased development of Canada's energy potential as producers are able to plan in a considerably less uncertain environment.

In return for enhanced access to the U.S. market, Canada has committed not to employ government price regulations to discriminate against U.S. energy purchasers by imposing differential prices. Canada has also committed to allow the United States "proportional access" to energy sources in the event of future diminished supply. This latter component of the agreement has drawn much attention from individuals concerned about Canada's future energy security. The final text of the agreement makes it clear that Canada retains the right, when it judges that a shortage of supply of an energy commodity exists, to restrict exports to the United States. But it would have to restrict exports on a proportionate basis, meaning that it would not be able to restrict supplies available to meet export contracts to a greater extent than supplies to meet domestic contracts. This approach basically extends the principle of multilateral sharing in the event of energy supply shortages to which Canada is already committed through the International Energy Agency.

The practical significance of Canada's energy-sharing commitment remains to be seen. Most of its energy exports are conducted under long-term contracts between Canadian producers and U.S. buyers. Since Canada already has legal obligations with respect to these exports, the sharing commitment merely assures U.S. purchasers of Canadian energy that they will not be cut off in the event of a temporary shortage. In the case of light crude oil, current projections based on diminishing oil reserves indicate that Canada will cease to be a net exporter to the United States by the early 1990s, thereby greatly reducing the practical significance of the sharing commitment. For heavy oils, Canada currently lacks upgrading capacity, meaning that heavy oils are only valuable to Canada insofar as they can be exported. If free trade encourages investment that leads to increased light oil reserves and expanded capacity to upgrade heavy oils, it can hardly be criticized for sharing this increased security with the United States.

In the end, the major practical significance of the energy component of the agreement is likely to be Canada's commitment not to discriminate against the United States on price, as it did from the mid-1970s to the mid-1980s — particularly under the National Energy Program (NEP) of 1980. It has long been understood that the NEP's pricing policies encouraged wasteful consumption and discouraged production.[15] Binding ourselves not to make this mistake again should not be viewed as a "concession" by Canada. Rather, it should be viewed as a challenge to develop improved policies for dealing with the disruptions and income distribution effects of energy shortages.

Tax reform will have a mixed impact on resource-based industries. The corporate tax changes included in the first stage of reforms will have an unambiguously negative impact, while the sales tax reforms promised in the second stage will have a mitigating positive impact.

Corporate tax reforms aim to narrow differences in effective tax rates across industries by reducing exemptions and deductions that favor particular industries or assets and by lowering corporate tax rates. The mining and oil and gas sectors have benefited in the past from favorable tax treatment, particularly from generous earned depletion and capital cost allowances. The Department of Finance

[15]See, for example, R.G. Wirick, "Managing Canadian Energy Demand and Supply," in Edward A. Carmichael and Corina M. Herrera, eds., *Canada's Energy Policy, 1985 and Beyond* (Toronto: C.D. Howe Institute, 1984), p. 81.

estimates that, prior to tax reform, the effective federal-provincial corporate tax rates on new investment for the mining and oil and gas sectors were −15.1 percent and 11.1 percent, respectively.[16] After reform, the new effective rates are estimated to be 8.7 percent for mining and 14.9 percent for oil and gas. Even though these two resource sectors would remain, along with agriculture, the lowest-taxed sectors in the economy, the increases in effective tax rates they face due to tax reform are substantially greater than for other industries.

John Whalley and Bob Hamilton, in their general equilibrium assessment of the tax reform proposals, estimate that the corporate tax reforms will reduce output in the mining and oil and gas sectors by approximately 9 percent. This is by far the largest negative impact on any sector of the economy. At the same time, Whalley and Hamilton estimate that sales tax reform will benefit resource-based industries. The removal of sales tax on capital goods and on the intermediate use of fuels will encourage increased production both at the primary level and in resource-based manufacturing industries.

Taken together, free trade and tax reform will have a beneficial impact on resource-based industries. Expanded and more secure access to the U.S. market will generate substantial long-term benefits to these industries. The opportunities generated by free trade will offset the negative short-term impact of corporate tax reforms that increase the effective tax rate on new investment in this sector. Resource-based industries would be in a stronger competitive position and able to benefit more from the new trade environment if the federal government proceeds with sales tax reform.

Other Manufacturing Industries

Apart from the resource-based industries, Canada's external trade is concentrated in a group of nonresource-related manufacturing industries. In this section, we divide these industries into three groups: nondurable manufacturing, transportation equipment, and other durable manufacturing. These three industries, which account for approximately 10 percent of Canadian jobs, include some of this

[16]Department of Finance, *Tax Reform 1987: Economic and Fiscal Outlook*, p. 6. A negative effective tax rate implies that the value of special tax provisions to the industry exceeds the taxable income generated by an investment in the industry.

country's most protected industries. They also include the automotive industry, which, in the auto pact, already enjoys virtually Canada-U.S. free trade. In spite of the fact that the auto pact has demonstrated the benefits of free trade, there is considerable concern that other manufacturing industries are "vulnerable", and that Canada will be a loser in these industries under free trade.

The manufacturing industries considered in this section will also be significantly affected by reform of the corporate and sales tax systems. Reduced capital cost allowances and investment tax credits, although offset by lower corporate tax rates, will increase effective tax rates on new investment in manufacturing. On the other hand, these industries stand to be major beneficiaries of sales tax reform.

Nondurable Manufacturing

The major factors that will influence the impact of free trade on individual industries include:

- the level of the tariff and nontariff barriers that will be eliminated;
- the responsiveness of each industry's exports and imports to reductions in trade barriers (economists refer to measures of responsiveness as the export and import elasticities of the industry);
- the mix, or ratio, of capital to labor used in each industry's production process;
- each industry's potential for increased productivity through rationalization and increased scale of production; and
- the degree to which imported products are good substitutes for domestically produced goods.[17]

In general, industries that will benefit from free trade are those that have low initial levels of protection (either in absolute terms or relative to the United States), relatively high export elasticities, high capital-to-labor ratios, significant unexploited rationalization potential or scale economies, and modest substitutability with U.S. imports.

The nondurable manufacturing industries listed in Table 5 are likely to face significant pressures to restructure; some of these indus-

[17]This list is based on Cox and Harris, "A Quantitative Assessment."

Table 5
Trade Barriers in Selected Canadian and U.S. Manufacturing Industries
(percentage equivalent of tariff and nontariff barriers)

	Canadian trade barriers	U.S. trade barriers	Difference	Estimated impact of free trade on output
Nondurables				
Rubber and plastics	8.9%	8.8%	0.1%	−0.7%
Leather	16.2	7.9	8.3	−7.2
Textiles	8.9	7.7	1.2	−1.0
Knitting mills	21.5	13.0	8.5	−1.5
Clothing	17.2	11.1	6.1	2.8
Printing and publishing	2.2	0.7	1.5	7.6
Chemicals	5.6	3.4	2.2	0.6
Miscellaneous	7.1	3.7	3.4	−1.0
Durables				
Transportation equipment	2.3	0.5	1.8	2.0
Furniture and fixtures	13.5	3.0	10.5	2.5
Machinery	5.6	5.5	0.1	3.3
Electrical products	7.0	3.8	4.8	−2.8
Nonmetallic mineral products	3.4	2.9	0.5	3.9

Source: S. Magun, S. Rao, and B. Lodh, *Impact of Canada-U.S. Free Trade on the Canadian Economy*, Economic Council of Canada Discussion Paper no. 331 (Ottawa, Economic Council of Canada, August 1987), pp. 25, 74.

tries will contract, and jobs will be lost. Industries such as leather products and knitting mills have tariffs that are high both in absolute levels and relative to the United States. Neither industry has significant unexploited rationalization potential or economies of scale. Both are highly labor intensive and subject to considerable import competition. To survive, firms in these industries will have to become more competitive by restructuring their production processes to match U.S. quality and productivity levels. They will need to increase the quality, distinctiveness, and price competitiveness of their products. Even in these relatively vulnerable industries, however, employment losses will be relatively small — less than 10 percent of industry employment — and should be largely absorbed over ten years by the normal turnover that takes place in these industries.

Other nondurable manufacturing industries that will face heavy competitive pressure include rubber and plastics, some segments of the textile and clothing industries, and parts of miscellaneous manufacturing. Not all of the nondurable group will contract, however. Although free trade may hurt some printing and publishing, clothing, and textile firms, major opportunities exist for increased sales in the United States for firms that have specialized skills and quality products.

Although these industries will face heavy pressures, they will play a fundamental role in generating the overall benefits to Canada from free trade. The benefits come from two sources: lower prices and increased choice for consumers of nondurable manufactured goods — from shoes to towels to plastic cups — and substantial improvements in the competitiveness and long-term economic viability of the firms in these industries that successfully adjust to free trade. While the task may appear daunting to some at the outset, it is worth noting that even in the most protected industries, the net tariff protection afforded Canadian firms will decline by less than 1 percentage point per year.

Transportation Equipment

The transportation industry is dominated by automobiles and parts — the one industry in which Canada already enjoys virtual free trade with the United States. Ironically, the main concerns about the auto industry have been that a comprehensive free trade agreement would *erode* the benefits of the auto pact.

Some people maintain that the auto pact represents managed trade, rather than free trade, because of production guarantees and content requirements that favor production in Canada. These so-called safeguards have not been binding for many years, however. Nevertheless, these people argue that by agreeing to eliminate all bilateral tariffs, Canada has given up the one penalty it could use to enforce the auto pact safeguards.

Another interpretation is that the automobile industry will continue to enjoy the favored position it was in prior to the agreement. Canadian auto producers covered by the auto pact will retain the right to import parts (and fully assembled vehicles) duty free from anywhere in the world and have these imported goods qualify for duty-free trade within North America. This is the single most im-

portant benefit to Canadian auto producers of retaining the auto pact — it saved them an estimated $300 million in import duties in 1986 and placed them on an even footing with U.S. producers. If Canadian producers covered by the auto pact fail to meet its safeguard requirements — namely, that they must produce one car in Canada for every car they sell in Canada and that cars and parts produced in Canada must have at least 60 percent Canadian value added — they would lose the valuable right to import duty free from Asia and other third countries.

In addition, the agreement specifies a new content requirement to qualify for duty-free trade between Canada and the United States. Fifty percent of direct manufacturing costs must be of North American origin. In the estimation of Canada's trade negotiators, this content requirement is about 40 percent more restrictive than the current rule of 50 percent North American value added.[18]

Therefore, the Canadian auto industry, which is already more competitive and profitable than its U.S. counterpart, has retained its free access to the U.S. market and its ability to import Asian parts and vehicles duty free. It has also achieved a more restrictive rule of origin than other products, which will encourage Canadian parts makers to compete for a larger share of the North American market.

Although Canada — and Ontario, in particular — has already reaped significant benefits from the auto pact, general equilibrium studies of free trade indicate that there is a further, perhaps substantial, gain still to be achieved. The main benefits would come from further industry rationalization and productivity improvement, particularly in the auto parts industry, and from the increased demand for cars arising from higher real incomes in Canada. The Economic Council of Canada estimates that free trade could add 2 percent to auto industry output and 3,000 jobs to industry employment.

Tax reform will also affect the auto industry significantly. Corporate tax reform that lowers rates and reduces investment writeoffs will have a mixed effect. With respect to profits from existing operations, the reduction in tax rates will lower the industry's current corporate tax liabilities. The effective tax rate on new investments will increase considerably, however, just as it did under the U.S. tax

[18]See testimony of Gordon Ritchie, Ambassador and Deputy Chief Negotiator, Trade Negotiations Office, to the House of Commons Standing Committee on External Affairs and International Trade, October 29, 1987, p. 50.

reform. For some parts producers that are expanding, corporate tax changes that increase the cost of capital could be a negative influence as they gear up to meet U.S. competition. This negative influence could be reduced or reversed, however, by reform of the federal sales tax. The auto industry currently bears a disproportionate burden of this tax — an important factor working against the competitiveness of Canadian producers. Sales tax reform is a much needed complement to free trade in automobiles as in other manufacturing industries.

Other Durable Manufacturing

The remaining segment of the manufacturing sector contains a group of durable goods industries, shown in Table 5. Apart from furniture and fixtures, absolute and relative tariff levels in these industries are fairly low. Two industries in this group — furniture and electrical products — likely will face heavy rationalization pressures under free trade. Two others — machinery and nonmetallic mineral products — are likely to expand. In the former two industries, Canadian tariffs are higher than U.S. tariffs, export elasticities are relatively low, and the degree of unexploited rationalization and scale economies is modest. In the latter two, Canadian and U.S. tariffs are virtually identical, capital intensity is relatively high, and rationalization economies are possible. On the whole, output and employment in these durable manufacturing industries will expand under free trade.

As for the impact of tax reform, exactly the same assessment as that made for nondurable manufacturers applies. Corporate tax reforms that raise the effective tax rate on new investment could hinder the rationalization process, but sales tax reform will work strongly in the opposite direction by increasing the competitiveness of Canadian-produced manufactured goods.

Construction and Services Industries

Conventional general equilibrium analysis has not focused much attention of the impact of free trade and tax reform on so-called nontraded sectors of the economy, including construction and commercial services industries. More recent studies indicate that the impact can be substantial, as shown in Table 6. The Economic Council of Canada remedies this shortcoming in its study. The Council demon-

Table 6
Potential Impact of Free Trade and Tax Reform on Output in the Construction and Services Industries
(percentage change)

	Free trade[a]	Tax reform[b]	
		Corporate tax	Sales tax
Construction	7.5%	2.3%	0.5%
Transportation/storage	2.7	2.5	0.5
Communications	0.5		0.9
Other utilities	2.7		0.9
Wholesale trade	3.7	1.6	0.7
Retail trade	4.4		−1.5
Finance, insurance, and real estate	4.3	1.6	0.8
Education and health	3.5		0.4
Amusement and recreation	5.5		
Business services	3.5		
Accommodation and food	4.4		
Other personal services	0.9		

Sources: *(a)* S. Magun, S. Rao, and B. Lodh, *Impact of Canada-U.S. Free Trade on the Canadian Economy*, Economic Council of Canada Discussion Paper no. 331 (Ottawa: Economic Council of Canada, August 1987), p. 74; *(b)* Bob Hamilton and John Whalley, "Efficiency and Distributional Effects of the Tax Reform Package", in Canadian Tax Foundation, *Proceedings of a Conference on the Economic Impacts of Tax Reform* (Toronto: Canadian Tax Foundation, forthcoming).

strates that, while the primary and manufacturing sectors will benefit from free trade, the largest absolute gains in terms of output and employment will occur in the construction and services sectors. Of the 350,000 jobs that the Council estimates free trade will generate, 48,700 will be in construction and 241,000 will be in the services industries. The exact numbers are not important. What is important is the clear message that the productivity and real income gains generated by free trade will spill over into increased demand, output, and jobs in the nontraded sectors.

Why is this the case? There are several reasons. First, as real incomes rise in industrial economies, the demand for services grows more than proportionately. As their incomes have risen, Canadians have spent an increasing portion on entertainment, recreation, travel, eating out, and all sorts of personal services. At the same time, the growth of business services — financial, legal, architec-

tural, management consulting — has expanded more rapidly than the goods-producing industries to which many of the business services are supplied. Thus, as industrial output and real incomes rise under free trade, demand for personal and business services will rise by even more.

Second, the services industries can also benefit from rationalization and scale economies under a free trade agreement that increases competition and expands the size of their markets. P.S. Rao and R. Preston estimate that the potential for increased productivity due to increases in the scale of production is approximately twice as large for services industries such as transportation, communications, utilities, and finance as it is for manufacturing.[19] Real income growth in Canada and increased access to the U.S. market, therefore, can further boost Canadian services industries.

Third, industry rationalization and the shift of resources toward Canada's export-oriented, capital-intensive industries will boost the construction industry under free trade. Construction of business plant, machinery, and equipment will benefit most from the necessary industrial adjustment. But stronger income growth will also have a positive impact on home building and increase the scope for expanded public-sector investment in infrastructure.

Tax reform further improves the prospects for the construction and services industries. Corporate tax reform will lower both average tax rates and effective rates on new investment for these industries. Effective rates on new investment will fall by 10–20 percent. Whalley and Hamilton estimate that corporate tax reform will lead to expansions of output ranging from about 1.6 percent in services to about 2.5 percent in utilities and construction. Sales tax reform will augment the expansionary impact of corporate tax reforms for all of the industries in the construction and services group with the exception of the retail trade industry.

The evidence of general equilibrium analyses of free trade and tax reform is that the construction and services industries will receive a strong boost in the new economic environment.

---

[19]P.S. Rao and R.S. Preston, *Inter-factor Substitution and Total Factor Productivity Growth: Evidence from Canadian Industries*, Economic Council of Canada Discussion Paper no. 242 (Ottawa: Economic Council of Canada, September 1983). For a further insightful discussion, see John Whalley, "'Trade, Industrial Policy, and Canadian Manufacturing' by Richard G. Harris (with the assistance of David Cox): A Review Article," *Canadian Journal of Economics* 17 (May 1984): 386–398.

These analyses also provide a clear answer to the question that skeptics of more neutral and competitive policies always ask: "Where will the jobs come from?" They will come in the tens of thousands in the primary and manufacturing sectors of the economy. And they will come in the hundreds of thousands in the construction and services sectors of the economy, where 75 percent of Canadian jobs already reside.

Conclusions and Unfinished Business

The major conclusions that flow from this assessment of general equilibrium analyses of the impact of free trade and tax reform can be summarized as follows:

- The potential benefits of free trade and tax reform are substantial and could increase the rate of growth of real per capita income by 50 percent in the first half of the 1990s.
- The impact of free trade and the first stage of tax reform will vary significantly across industries. In resource-based industries, the positive impact of free trade will be offset by the negative impact of corporate tax reform. In several manufacturing industries, rationalization pressures from free trade will be compounded by higher effective tax rates. In construction and most services industries, the positive (mainly indirect) impact of free trade will be augmented by a lightening of the tax load.
- Those industries in the manufacturing sector that will face the most difficult adjustments to free trade and an increased corporate tax burden stand to gain most from reform of the federal manufacturers' sales tax.

If the full benefits of the more neutral, competitive, and predictable economic environment are to be achieved, the federal government will have to get on with the task of completing its free trade and tax reform initiatives. The major pieces of unfinished business include implementation of the free trade agreement; successful negotiation of new bilateral antidumping, countervail, and subsidies rules to replace national laws; and, as the centerpiece, follow-through on the second stage of tax reform. We outline the policy

agenda for completing the unfinished business of free trade and tax reform in detail in Chapter 4.

As governments work at completing these tasks, the private sector needs to be gearing up to make the most of the opportunities that will be created. All of the gains from free trade and tax reform that have been discussed in this chapter are "potential", in the sense that they are based on the assumption that the private sector is ready and able to take advantage of improved access to the U.S. market and the more neutral tax regime. Corporate and individual adjustment is the key to turning these potential benefits into reality.

3

Facing Up to Global Agricultural Realities

It is time we returned some sanity to agricultural trade.

Hon. Pat Carney
October 20, 1987

Introduction

The agricultural sector faces a number of challenges that are not fully dealt with by the federal government's tax reform and free trade initiatives. The fundamental problem is that agricultural subsidies in the major producing countries threaten the viability of the Canadian farm sector and are likely to add substantially to government expenditures in the years to come. Finding cost effective ways of cushioning the impact of foreign subsidies on Canadian farmers is therefore a priority. New initiatives also are required to enable agriculture to better meet the challenges posed by fundamental changes in global agricultural markets.

The problems facing agriculture are more difficult than those characterizing some other sectors of the economy, because they are largely international in origin and because resources cannot move in and out of agriculture as readily as they are shifted between other activities. Strategies for agriculture require a longer-term view, which is made difficult by the inherent instability of food supply and demand.

Several things are clear, however. First, Canadian agricultural policy needs to come of age. The market reality of 20 years ago, that of producing vast quantities of grain for a hungry world, has given way to a reality characterized by massive food stockpiles, depressed commodity prices, and dwindling farm incomes. Measures are now required that recognize these new realities and encourage producers to be more responsive to them.

Second, the policy response to the recent decline in farm incomes is distinctly *ad hoc* in nature. The strategy has been to compensate producers for the extent to which market returns fall short of providing acceptable incomes. Under these conditions, a continuation of depressed prices for major farm exports runs the risk of seriously increasing government expenditures. Budgetary constraints dictate that fiscal exposure in this area be controlled.

The need for financial assistance for farmers in bad times is something Canadians accept. That does not imply, however, that governments have a *carte blanche* to support farm incomes heavily and indefinitely. Prudent long-term strategies are required that reflect changed world market realities and that assist Canadian farmers in adjusting to these realities.

An Overview of Canadian Agriculture

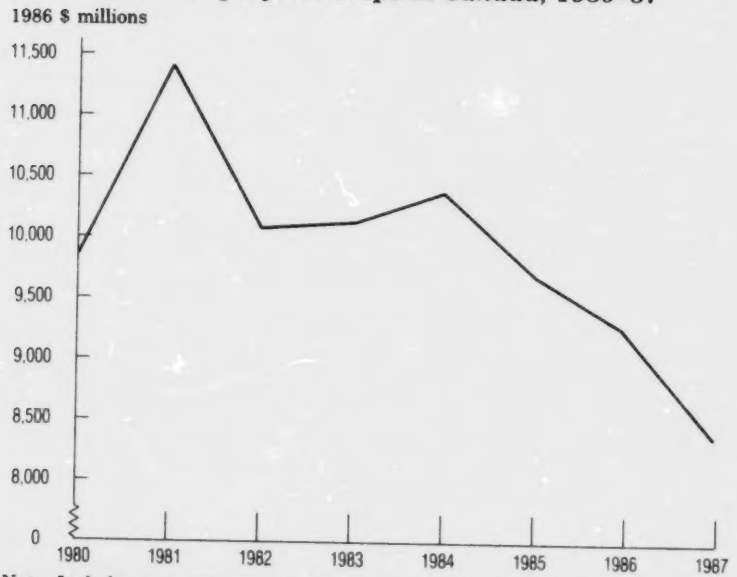
The importance of agriculture to the Canadian economy is much greater than its 3 percent share of national income and 4 percent share of employment suggest. The agribusiness sector, which includes activities as diverse as fertilizer suppliers, food processors, and distributors, accounts for roughly one-fifth of GNP. Primary agriculture also plays a critical role in the economies of some regions, most notably Western Canada. Farming is the primary economic activity in many rural centers and, consequently, its well-being has widespread implications for rural society. Finally, agricultural commodities — grains, in particular — are a major contributor to Canada's trade balance, accounting for over 8 percent of the value of Canadian merchandise exports in 1986.[1]

Consider how an outsider would view the Canadian agricultural sector. Several key characteristics are obvious immediately: a plentiful supply of relatively low-cost land, a harsh climate that limits the crops available for production, an excellent grading and inspection system that ensures high-quality food items for export, and relatively high labor costs in downstream activities such as slaughtering and processing.[2] It is probably safe to say that Canada has

[1]Statistics Canada, *Exports: Merchandise Trade 1986*, Cat. no. 65-202 (Ottawa, 1987), based on Table 1.

[2]See L.W. MacLeod, "The Competitive Position of the Canadian Slaughter and Processing Industry," in Department of Agriculture, *Proceedings of the Canadian Agricultural Outlook Conference, December 1986* (Ottawa, 1986), pp. 122-129.

Figure 5
Cash Receipts from Crops in Canada, 1980–87



Note: Includes payments made under the Western Grain Stabilization Plan, and through the Canadian Wheat Board and crop insurance.

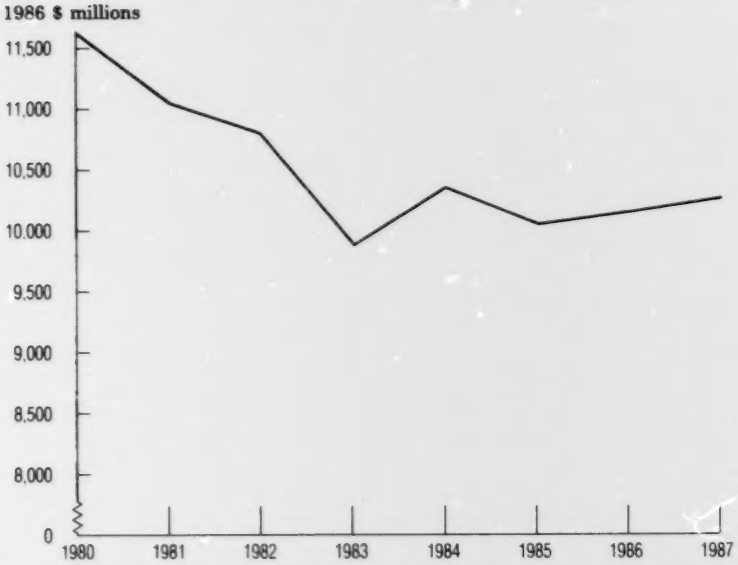
Sources: Department of Agriculture, *Handbook of Selected Agriculture Statistics 1986* (Ottawa: Supply and Services Canada, 1987); and idem, *1987 Farm Income Highlights* (Ottawa, December 1987).

a comparative advantage in the production of certain agricultural commodities, most notably livestock and grains.

Grains, which include wheat, oats, barley, and rye, are the largest product category, accounting for approximately one-fifth of farm cash receipts from farming operations (see Figure 5 for total cash receipts from crops during the 1980–87 period). Grain production, valued at $4 billion in 1986,[3] is largely concentrated in the Prairies, and close to 80 percent of it is exported. Canada has been able to maintain its approximately 23 percent share of world grain exports

[3]Based on the value of farm cash receipts in 1986. See Statistics Canada, *Farm Net Income, 1986*, Cat. no. 21-202 (Ottawa, 1987).

Figure 6
Cash Receipts from Livestock and Livestock Products in Canada, 1980–87



Sources: Department of Agriculture, *Handbook of Selected Agriculture Statistics 1986* (Ottawa: Supply and Services Canada, 1987); and idem, *1987 Farm Income Highlights* (Ottawa, December 1987).

in recent years, although world grain trading volumes have declined throughout the 1980s.[4]

Cash receipts from livestock production (shown in Figure 6) account for roughly 57 percent of Canadian farm cash receipts from market sources. Contrary to trends in other segments of agriculture, the livestock sector's profitability has increased over the past five years as a result of low feed grain prices and exchange-rate movements. Livestock production occurs in most regions, although Alberta and Quebec are particularly active in the production of cattle and hogs respectively. Canada is competitive in most aspects of

[4]Based on data provided by the U.S. Department of Agriculture and reported in United States Embassy, "World Wheat Trade: Oversupply Heightens Competition," *Backgrounder* (Ottawa, 1986). Between the 1980–81 and 1985–86 crop years, world wheat trading volumes fell by 10 percent.

livestock production and has operated successfully under a free trade environment with the United States in this industry for many years.

The dairy, egg, and poultry industries function under a supply management system. Production quotas are allocated and prices established in order to maintain orderly markets and stable producer incomes. Canada exports very little of these commodities.

It is important to keep in mind the diversity of Canadian agriculture when formulating agricultural policies. The problems of unstable incomes and farm debt are fairly universal. Other challenges facing the agricultural sector, however, are specific to particular commodities. Therefore, although problems in international grain markets dominate, complex problems facing other parts of agriculture require different kinds of policy responses.

The Challenges Facing Canadian Agriculture

Canadian agriculture faces a variety of challenges, some arising out of changing global supply and demand conditions and some out of specific Canadian concerns. In the following section, we provide a summary of these major challenges.

Farm Subsidies and Support Programs

This is the most pressing problem affecting Canadian agriculture. Together, the United States and the European Community (EC) budgeted over U.S. $50 billion on agricultural spending in the latest fiscal year. Spending on the Japanese agricultural sector amounted to another U.S. $10 billion.

The desperate need for reform of agricultural policies is perhaps best illustrated by the irony that overall financial support to farmers continues to increase at a time when commodity surpluses are at record high levels and 500 million people around the world remain undernourished.

It is often claimed that the EC's Common Agricultural Policy (CAP) was the instigator of the international agricultural subsidy war. As a result of the CAP, which accounts for over two-thirds of the EC's total budget, Europe has gone from being one of the world's largest food importers to being an important exporter of agricultural products in the period since 1970. The EC obtained its share of international markets largely at the expense of U.S. producers. During the 1981–85 period alone, the U.S. share of world grain

markets fell to 29 percent from 48 percent, while the EC share increased from 5 percent in 1973–74 to 17 percent in 1985–86.[5] Largely in order to recapture what was considered to be its "fair share" of grain exports, the United States introduced the *Food Security Act* in 1985. Spending on the U.S. farm sector was estimated to be U.S.$36 billion in the past year.

The EC and the United States are by no means alone in pursuing agricultural support strategies, although their policies tend to have the most distortionary effects because of the sheer size of expenditures involved. In fact, there are no "free traders" among the world's agricultural producing countries. There are many striking examples of agricultural protectionism practised by foreign governments. The Japanese, for example, pay rice growers over three times the world price for their crop; the Saudis pay grain producers as much as $1,000 per tonne, or roughly ten times world price, to grow wheat in the desert.

U.S. Department of Agriculture estimates of agricultural support levels by commodity for various countries over the 1982–84 period are shown in Table 7. Commodity support is evaluated according to the Producer Subsidy Equivalent, which represents the direct subsidy required to replace all support programs and leave farm income unchanged — that is, the dollar value of all transfers by direct and indirect programs.[6] In most countries, food grain, dairy products, and sugar are the most heavily protected, while poultry and pork are relatively little protected. In many cases, producer subsidies are accomplished through consumer taxes in the form of high food prices. The exceptions to this are wheat and sometimes dairy products, for which consumer prices usually are kept low. In developing countries such as Argentina, Brazil, India, and Nigeria, agricultural producers are frequently taxed on their exported commodities.

Overall, Canada's support for agriculture is approximately equal to that provided in the United States, less than that in Japan and the EC, and higher than that in Australia. Compared to the United States, Canadian farm support is more widely distributed across

---

[5] *Ibid.*

[6] Controversy still surrounds the use of the Producer Subsidy Equivalent as a quantitative measure of commodity protection levels. While the concept is simple in principle, it does not easily include the effects of programs such as supply controls, input subsidies, voluntary export restraints, and shared risk programs. Most importantly, the Producer Subsidy Equivalent, like other quantitative measures, does not provide an accurate picture of the trade distortions cause by agricultural protection.

Table 7
Producer Subsidy Equivalent Levels by Country and Commodity, 1982–84[a]

Commodity	United States	Australia	Canada	European Community	Japan	South Korea	Brazil
Wheat	high*	low*	medium*	medium* for common high* for durum	high	high	high
Rice	high*	medium*		high	high	high	high
Corn	high*		low	low		high	producer tax
Barley	medium*	low*	medium*	medium*	high		
Soybeans & products	low*		low	high	high	high	producer tax*
Other oilseeds			medium* (canola) medium* (flax)	high (canola)			
Sugar	high	medium*	high	high*	high		
Cotton	high*	low*					high*
Dairy products	high*	high*	high*	high*	high	high	low
Beef	low	low*	low	high*	high	high	producer tax*
Pork	low	low*	low*	medium*	high	high	
Poultry meat	low	low*	medium	high*	high	medium	low*

[a]The Producer Subsidy Equivalent represents the direct subsidy required to replace all support programs and leave farm income unchanged — that is, the dollar value of all transfers by direct and indirect programs. A "low" level is defined as a producer subsidy of 0 to 0.09; a "medium" level as a producer subsidy of 0.10 to 0.24; and a "high" level as a producer subsidy of 0.25 to 0.99.

Note: An asterisk denotes a net exporter during the 1982–84 period. Some products lack data for some years.

Source: U.S. Department of Agriculture, Economic Research Service, *Government Intervention in Agriculture: Measurement, Evaluation, and Implications for Trade Negotiations*, Foreign Agricultural Economic Report 229 (Washington, D.C.: U.S. Government Printing Office, April 1987), p. 29.

commodities and is delivered through stabilization programs, transportation subsidies, supply management, and, more recently, deficiency payments. U.S. trade barriers focus primarily on the grains sector and include price support loans, deficiency payments, storage programs, and government commodity purchases.

The problem with agricultural support programs is not simply with the absolute level of money spent but with how the support is distributed. Most agricultural programs allocate financial support according to some measure of output or provide commodity price guarantees. Either way, the programs distort market signals and encourage overproduction. Countries then rid themselves of excess production by subsidizing exports to the few export markets that still exist.

Canada was shielded in the early 1980s from the worst consequences of world agricultural subsidies. President Carter's embargo on U.S. grain exports to the Soviet Union and a strong U.S. dollar combined to maintain a healthy demand for Canadian grain exports. In the past two years, however, the disarray in world food markets has fed through to Canadian producers. Grain prices have fallen by 40 to 50 percent, and competition has intensified in world food markets. Because Canada exports a far greater share of its agricultural production than does the United States or the EC, it has less capacity to shift the burden of agricultural support to domestic consumers through higher food prices. Depressed international food prices have direct and immediate consequences for Canadian farm revenues.

The Loss of Traditional Markets

For Canada, the major consequence of foreign agricultural support programs has been that competition from subsidized foreign commodities has intensified in many of its traditional export markets. Although Canada was insulated from the worst effects until recently, the past two years have seen the United States — a major competitor — negotiate export deals for grain, oilseeds, and milk with China, Brazil, India, and the Soviet Union.

The terms of sale with which competitors close such deals have created serious problems for Canadian farmers, since the subsidy component can be as large as 30 percent of the final selling price. In the U.S. case, its Export Enhancement Program enables producers to sell at far below market prices. In addition, private exporters arranging sales to foreign purchasers at low prices can have their supplies reimbursed by U.S. government grain stockpiles.[7]

[7] "Canadian farmers decry subsidized U.S. exports," *Globe and Mail* (Toronto), November 8, 1987.

The quantities involved in these U.S. sales are large enough to make a major difference in the market. Canadian wheat marketers feel that unless they further reduce their prices significantly, they face an eroding share of major grain and oilseed markets.

There is also concern that structural factors are at work that will result in a permanent loss of many of Canada's traditional export markets. Privatization initiatives in China, which now takes 20 percent of Canada's grain exports, could result in reduced demand for foreign grain. Other countries, such as India, are moving rapidly toward self-sufficiency in grain production. There is also speculation that Soviet grain imports will decrease as a result of intensive farming practices introduced in 1985.

Of Canada's major export markets, only Japan is expected to remain a net food importer in the long term. Even here, Asian producers such as Thailand and South Korea are likely to displace industrialized countries such as Canada as major suppliers to the Japanese market. There are mixed views about the Soviet Union's likelihood of achieving food self-sufficiency. Even if the Soviet Union continues to be a net importer, further downward pressure may be exerted on world grain prices as competition intensifies among world producers to supply the Soviet market.

Technological Advancements

Canadian agriculture also faces increased competition in export markets because of technological innovation. Technology has changed traditional definitions of comparative advantage, making production possible in areas of the world previously thought unsuited to agricultural development.

Genetic research, through the introduction of faster-maturing crop varieties, has substantially increased the zone of cultivation. The Green Revolution of the late 1960s and early 1970s resulted in wheat, rice, and corn varieties of two to three times the yields of earlier strains. The combination of intensive fertilizer and pesticide use, irrigation, mechanization, and better seed has been responsible for Punjabi wheat, Indonesian rice, Zimbabwean corn, and other agricultural success stories.

Canadian farmers, who already face more serious financial difficulties than their U.S. or European counterparts, are under considerable pressure to adopt new agricultural technologies in order to main-

tain competitiveness. Ultimately, while farmers incur the costs associated with the implementation of technology, many of the benefits accrue to consumers through lower commodity prices. Hence, technology is a necessary force in agriculture, but not one that necessarily works to the advantage of the producer.

Weak Demand Growth

As competition for traditional export markets intensifies, demand growth both in the developing countries and in the domestic market is likely to be slower than has been experienced over the past ten to twenty years.

While there continues to be vast demand potential among the developing countries, competition from other exporters, increasing food self-sufficiency in many of these countries, problems of foreign debt, and a projected deceleration in population growth will limit Canada's ability to expand exports there significantly. Grain is the primary commodity imported by the developing countries, and there is some suggestion that Canada's high-quality, high-priced product will put it at a disadvantage in this market.[8]

The Canadian domestic market shows little potential for expansion. The domestic population is likely to grow only slowly, and there is a limited capacity for increasing the food consumption of Canadians. Economists consider most food items to have a very low income elasticity of demand, meaning that demand for food tends not to increase in proportion to increases in income. There are limits to the amount of food a person can consume, regardless of how wealthy that person is, whereas the same is not necessarily true for other consumer products.

What holds true for the Canadian domestic market also applies to markets in other industrialized countries. In the Organisation for Economic Co-operation and Development (OECD), overall food consumption is forecast to increase by as little as 1 percent per year over the balance of the decade, even in the face of falling prices.[9] Most of the growth that will occur in these countries will be for processed, higher-value-added food products, the benefits of which

---

[8]Canada, Task Force on Program Review, *Agriculture, A Study Team Report* (Ottawa: Supply and Services Canada, 1986), p. 12.

[9]Organisation for Economic Co-operation and Development, *National Policies and Agricultural Trade* (Paris: OECD, 1987).

tend to accrue more to manufacturers and distributors than to primary producers.

Changing Consumer Demands

Within the domestic market, increasingly sophisticated consumer demands pose a challenge to Canadian farmers. Recent domestic consumption trends include an increased preference for imported foods and shifts away from the consumption of products such as red meats. Consumers place a premium on freshness, quality, and variety, which requires farmers and food distributors to be more flexible in their production and more aggressive in their marketing of commodities.

In international markets, producers are also required to be more responsive to the specific demands of foreign consumers, whether it involves catering to the Japanese preference for leaner cuts of meat or Africans' demands for lower qualities of grain.

Agricultural Cycles

Cycles have always been a fact of life for the agricultural producer. For example, the average annual variation in realized net farm income in Saskatchewan over the 1926–81 period was 61 percent.[10] In recent years, however, instability in farm incomes has been caused not only by the weather, production cycles, and pests but also by unusually wide fluctuations in interest rates, exchange rates, and international commodity markets.

Recent studies have shown that agricultural cycles have become more pronounced as a result of increased integration of world food markets.[11] Farmers have little ability to protect themselves from income fluctuations, since their entire net worth tends to be concentrated in assets whose returns respond in similar ways to changes in interest and exchange rates. Cycles make planning decisions more difficult and put pressure on governments to mitigate the resulting volatility in producer incomes.

---

[10]Jacques Jobin, *Farm Instability on the Prairies*, Economic Council of Canada Discussion Paper no. 273 (Ottawa: Economic Council of Canada, 1985), p. 44.

[11]According to estimates by Maurice Schiff, the variability of world wheat prices could have been reduced by 48 percent if all countries had ended their protective wheat policies. See Maurice W. Schiff, *An Econometric Analysis of the World Wheat Market and Simulation of Alternative Policies, 1960–80*, ERS Staff Report (Washington, D.C.: U.S. Department of Agriculture, International Economics Division, 1985).

Increased Global Integration of Agricultural Markets

Canada earns roughly one-half of every dollar of agricultural sales from exports compared with one-quarter for the EC and one-fifth for the United States. A high level of international integration thus means that domestic producers are more sensitive to policy actions undertaken by foreign governments than are their counterparts in the EC and the United States. It also means that Canada's trading partners focus more attention on Canada's agricultural programs. This ultimately limits the scope for domestic policy solutions to deal with current agricultural problems.

Farm Debt

Farm debt is one of the challenges not directly caused by Canada's external trading environment. The farm debt crisis can be traced to the optimism of the 1970s, which was reflected in easy credit policies, inflated land prices, and government strategies to encourage output. Although the rate of growth in farm debt has slowed since the 1970s, recent decreases in farm asset values have meant further deteriorations in the financial condition of Canadian farmers. Recent Department of Agriculture figures show that approximately 35 percent of the average farmer's income goes to service debt.[12]

Interest payments as a share of farm receipts, which are in the 10 percent range, remain very high by historical standards. The threat of further farm bankruptcies puts pressure on financial institutions, particularly credit unions, and on government credit agencies. The federal government's Farm Credit Corporation itself faced the possibility of insolvency, with uncollectible debts totaling $344 million in 1986, until the federal government stepped in to forgive many of the debts in December 1987.

While many of the solutions to the debt problem lie in improved demand and increased prices for agricultural commodities, a substantial rethinking of the farm financing issue is also needed. We should look to alternatives to the current situation, which obliges young farmers to acquire the full asset value of their farm immediately on entry to the industry.

---

[12]See Oliver Bertin, "Aid plans should bring record farm income," *Globe and Mail* (Toronto), December 15, 1987, p. B1.

Farm Lobby Groups

The emergence of farm lobby groups created to defend the interests of their agricultural constituents has made agricultural policymaking more complex in recent years. The demands of farm lobby groups for increased support are difficult to resist, and often win out when balanced against the diffuse calls of taxpayers for budget restraint.

Because today's producer groups tend to be drawn more along commodity lines, consensus on general issues affecting the agricultural sector is more difficult to achieve. For instance, a great deal of attention now is focused on maintaining the power of supply management boards and on extending the government support the grain industry currently receives to other producers.

Strong producer groups are necessary to represent the interests of individual producers against strong marketing institutions and a highly concentrated food-processing industry. However, to the extent that sectoral self-interest predominates the agenda, an equitable balance between the needs of different sectors will be difficult to achieve.

The Increasing Role of Government

Largely as a result of the foreign subsidy and oversupply situation, government spending on agriculture has reached unprecedented levels. Federal and provincial government expenditures totaled close to $6 billion in 1986. Expenditures of this magnitude are difficult to justify at a time of budget restraint, when spending increases in other sectors have been severely curtailed.

Of particular concern to policymakers and farmers alike must be the *ad hoc* way in which agricultural support is provided. Federal programs such as the Special Canadian Grains Program compensate producers for the extent to which returns from market sales fall short of providing a reasonable income. The federal government alone allocated $3.9 billion in direct cash payments to farmers in 1987, which accounted for 22 percent of total farm cash revenue.[13]

As the system now exists, further deteriorations in international prices could increase governments' financial commitment to the agricultural sector. It is worth repeating that because exports ac-

---

[13]*Ibid.*

count for a greater proportion of farm production in Canada than in most other countries, Canada's fiscal responsibility is also greater, since there is less capacity to shift some of the burden of farm support to domestic consumers.

Taxpayers have an obvious interest in seeing agricultural spending reduced or at least structured in such a way that limits government spending responsibilities. Many producers also consider the current situation to be unappealing. The agricultural sector does not have a history of direct government income support, and farmers realize that government support given one year can be just as easily refused the next. Producers would prefer a system that insures them against severe income swings but that does not require government expenditures of the highly visible and arbitrary nature of current programs.

The Situation on the Farm

In summary, international agricultural markets are characterized by excess supply, depressed prices, and fierce competition for the few buyers who remain. This situation is largely attributable to excessive government subsidy and support practices aimed at increasing food production and exports. As a relatively small producer with little market power, Canada's only real alternative in the short term has been to compensate producers for the extent to which depressed prices have eroded their incomes.

Also at work are supply factors of a more structural nature, which have increased farmers' ability to produce food and deliver it to the consumer. Farm subsidies have drawn too many resources into agriculture, and structural factors have increased the productivity of those resources already there. The result is too many farms and too much output. This has particularly affected Canadian producers who would otherwise have a comparative advantage in food production.

On the demand side, export markets are shrinking as a result of increased food self-sufficiency and fierce competition from new producers. Demand growth, even in the developing countries, is predicted to be weaker than in the recent past. While food supply and demand are inherently unstable, many of the factors influencing supply appear to be permanent in nature. Therefore, the cur-

rent situation of excess supply in agricultural markets probably reflects a long-term trend rather than a temporary aberration.

Government payments account for an increasing share of agricultural incomes in Canada. The system of government support has become highly politicized as disbursements, particularly to the grains sector, are made on an *ad hoc* basis.

This situation is not sustainable. Farmers are not assured an adequate income from sales at current commodity price levels. Taxpayers probably are not willing to finance the shortfall indefinitely. A reduction in international farm subsidy levels would ease most, if not all, of the problems Canadian farmers face. The next section considers previous Canadian efforts to liberalize agricultural trade and assesses the likelihood of achieving reductions in foreign farm subsidies.

Agricultural Trade

Previous Canadian Initiatives

The decision to include agriculture in the new round of trade negotiations under the General Agreement on Tariffs and Trade (GATT) was an important achievement. Promising rhetoric also came out of the Tokyo Summit of May 1987 and the Venice meeting one month later of the seven major industrialized countries. These encounters produced, among these countries, an acknowledgement of "the agricultural problem", an admission of their collective and joint responsibility for its occurence, and an endorsement that eliminating the linkage between supports and production levels would be the way to proceed in achieving reform.

Canada was an early advocate of agricultural trade reform and has taken an aggressive stance in arguing for liberalization in the multilateral arena. It has assumed a leadership role in the Cairns group of 14 agricultural-exporting countries[14] in calling for alternatives to the damaging subsidies practised by the EC and the United States.

The Canadian government recently tabled its negotiating position for agriculture at the Uruguay Round of GATT negotiations.

[14]The 14 countries are Argentina, Australia, Brazil, Canada, Chile, Colombia, Fiji, Hungary, Indonesia, Malaysia, New Zealand, the Philippines, Thailand, and Uruguay.

Its position represents an ambitious but realistic middle ground between the U.S. proposal that all agricultural trade barriers and subsidies be eliminated over a ten-year period and the EC submission that proposes vague changes over an unspecified period of time.

Canada's negotiating position calls for some flexibility in agricultural policy, arguing that those programs that do not distort trade be permitted. It calls for the development of a qualitative measure, based on the Producer Subsidy Equivalent, for negotiating the reduction of barriers and trade-distorting subsidies, with omissions allowed for those measures agreed to be "trade neutral". While negotiation on the elements of this "trade distortion equivalent" and a timetable for reductions in barriers and subsidies would be a primary focus of attention, Canada also has called for the drafting of clear rules specifying which agricultural policy instruments would be acceptable under the GATT.

Since the problem of agricultural subsidies is multilateral in origin, Canada and the United States were unable to accomplish much in this area in the free trade agreement, beyond prohibiting export subsidies on bilateral trade and agreeing to take the other's interests into account when subsidizing exports to third countries.[15] The agreement will free some agricultural trade — most notably in the livestock industry, where technical regulations will be harmonized and where there will be mutual exemptions from meat import laws for beef and veal. Canada's supply management system will be preserved for the turkey, chicken, egg, and dairy industries, although import quotas will be eased slightly for poultry and eggs. Overall, the trade agreement means few adjustments for Canadian agriculture, both because it provides for little change and because Canada's major export markets for most agricultural commodities are offshore, not with the United States.

The Prospects for Improving Multilateral Trade

What progress can be expected in the multilateral area? Robert Paarlberg, author of a recent report for the U.S. Council of Foreign Relations, provides the following summary of various studies on the impact of reductions in agricultural trade barriers and subsidies:

---

[15]Recent U.S. export deals with the Soviet Union, China, and India cast some doubt on its commitment to consider Canadian interests when subsidizing exports to third countries.

> If national food and agricultural policies were liberalized, world agricultural prices would become more stable, the total volume of trade would grow, and both the structure of global agricultural production and the direction of trade would become more efficient. This would provide large net welfare gains to practically all nations concerned.... Interestingly enough, the only big net losers would be the Soviet and East European nonmarket economies, which would lose the access which they now enjoy, through depressed and distorted world farm markets, to artificially cheap supplies of food.[16]

While overall gains from trade liberalization would be considerable, the impact on the location of production and the direction of trade casts some light on the reluctance of the major actors to reduce their levels of protection. Simulations done for the OECD and the World Bank[17] conclude that cutbacks in agricultural trade barriers and support levels would lead to a slight increase in commodity prices and trading volumes but to decreases in production among the industrialized countries. According to the World Bank study, while consumers and taxpayers in the OECD countries would incur a net gain of U.S.$104 billion from agricultural trade liberalization, this would be achieved at the cost of a net loss of U.S.$56 billion to farm producers.[18] The fact that farm incomes would be negatively affected if current support structures were dismantled underlines the difficulties inherent in eliminating agricultural subsidies.

These analyses also conclude that the substantial overall gains occurring from trade liberalization depend critically on the EC's reducing its agricultural support levels in a meaningful way. Despite Britain's increasingly vocal opposition to the CAP, the political dynamics involved suggest there is little likelihood of this taking place. The commitment to the present system is very strong among European farmer-constituents, especially those in France and West Germany. The EC's rather vague negotiating position for the Uruguay Round leans more in the direction of "managed" trade in agriculture than liberalized trade. In the minds of most European producers,

---

[16]Robert L. Paarlberg, *Fixing Farm Trade: Policy Options for the United States*, The Council on Foreign Relations Series on International Trade (Cambridge, Mass: Ballinger, 1988), p. 32.

[17]OECD, *National Policies and Agricultural Trade*; and World Bank, *World Development Report 1986* (New York: Oxford University Press, 1986), Chapter 6.

[18]World Bank, *World Development Report 1986*, p. 131.

public management of the agricultural sector is an undeniable characteristic of the modern economic system.[19]

There is also reason to question the degree of commitment U.S. farmers have to their country's proposal to the GATT. In fact, there is some doubt that politically powerful farmers in the United States would agree to forego the lucrative government assistance they now receive.[20]

The fact remains, however, that the budgetary gains arising from a reduction in support would be more than sufficient to compensate producers for any loss in farm income. A progressive substitution of direct income support for measures that distort production, trade, and consumption is the best hope for resolving the world farm subsidy crisis.

Countries should also acknowledge that, as a result of advances in productivity and technology, there are more agricultural producers in the world today than can be justified by the market. Unless the number of producers is reduced, the problems of commodity oversupply and low farm incomes will persist indefinitely. Farm policies should lessen their focus on supporting marginal producers and let markets determine to a greater extent the amount of resources that should be devoted to agriculture.

The Scope for Canadian Trade Policy

As a relatively small producer and a minor offender in the area of farm support, Canada cannot be expected to take a leadership role in dismantling support structures. However, it can and should continue to press aggressively for trade liberalization in the multilateral forum and through groups of like-minded countries such as the Cairns Group. It should emphasize the development of realistic alternatives to current support policies and specific guidelines for reducing international trade barriers. It can also push for effective measures to limit technical barriers to trade and for the development of international standards in this area.

---

[19]See Victoria Curzon Price, *Free Trade Areas, the European Experience: What Lessons for Canadian-U.S. Trade Liberalization?*, Observation no. 31 (Toronto: C.D. Howe Institute, 1987), p. 9.

[20]See Dale Hathaway, *Agriculture and the GATT: Rewriting the Rules* (Washington, D.C.: Institute for International Economics, 1987).

The Goals and Instruments of Canadian Agricultural Policy

The most effective solution to the problems that Canadian farmers face must await the resolution of the international subsidy and oversupply situation. This, however, may be some years away. What can domestic agricultural policy do in the meantime to address the concerns of Canadian farmers? First of all, it is worthwhile examining the functions of Canadian agricultural policy and the policy measures now in place.

The traditional objectives of agricultural policy in Canada, as expressed in 1977 by the Department of Agriculture, can be summarized in the following three points:

- consumer objectives, such as the maintenance of reasonable and stable food prices, an adequate and dependable food supply, and high-quality and nutritious food;
- producer goals, such as the provision of a fair and stable income to producers and a degree of equity between agricultural producers and among producing regions; and
- broader goals, including an improved quality of rural life, a balance between rural and urban population, conservation of the resource base, and fulfillment of international responsibilities in food and agriculture.[21]

Financial security and income stability for producers continues to be a primary objective of policymakers, as evidenced by the transfer to producers, in 1986, of $1 billion under the Special Canadian Grains Program and an additional $1 billion under the Western Grain Stabilization Plan. In December 1987, the federal government announced a further $2.8 billion package of farm support, including $1.1 billion in deficiency payments.

---

[21]These objectives are summarized in J.D. Forbes, R.D. Hughes, and T.K. Warley, *Economic Intervention and Regulation in Canadian Agriculture* (Ottawa: Economic Council of Canada and the Institute for Research on Public Policy, 1982), p. 17. The federal government has restated these goals a number of times since 1977, but they remain little changed. One of the most recent examinations of policy objectives was contained in a report of the Ministers Responsible for Agriculture, *A National Agriculture Strategy: Report on the Challenges Facing Agriculture*, submitted to the Annual Conference of First Ministers, Vancouver, 1986.

Table 8
The Cost of Purchasing a Basket of Food Items in Various Countries, 1983
(U.S. dollars)

Country	Cost	Country	Cost
Japan	$36.37	United Kingdom	$19.34
Switzerland	36.03	France	18.90
Sweden	27.72	Canada	18.79
South Korea	23.01	South Africa	16.96
Italy	20.54	Mexico	10.99
United States	20.21	Brazil	9.92

Note: Based on the capital cities of the respective countries.

Source: Ontario, Ministry of Agriculture and Food, *Facts and Figures on the Agri-food Sector*, October 1987, p. 5.

The importance attached to regional development objectives is demonstrated by agricultural policies such as the *Western Grain Transportation Act* and the Feed Freight Assistance Program, which aim to alleviate locational disadvantages in the production and marketing of agricultural commodities.

The preservation of the family farm and rural agricultural communities is still very much a cornerstone of Canadian agricultural policy. While programs have been designed to support or stabilize farm incomes, less emphasis has been placed on encouraging adjustment within the sector or moving resources out of agriculture, even in the face of declining returns and excess production.

Finally, agricultural support in Canada has been accomplished largely through government expenditures, not through higher consumer food prices. As Table 8 shows, Canadian food prices are among the lowest in the world. As a percentage of disposable income, Canadians spend less on food than do people in any other country except the United States.

In implementing its objectives, Canadian agricultural policy has evolved in the following six broad categories:

- production assistance;
- income stabilization and other risk-management programs;
- transportation subsidies;

Table 9
Federal and Provincial Government Agricultural Support, 1980–82 and 1985–87

Program	Amount ($ millions) 1980–82	1985–87	Distribution (%) 1980–82	1985–87
Farm credit	$ 171.2	$ 393.6	5.6%	8.4%
Production assistance[a]	638.6	865.1	21.0	18.4
Stabilization	611.4	656.9	20.1	14.0
Crop insurance	140.0	261.7	4.6	5.6
Transportation	423.3	1,007.5	13.9	21.5
Marketing	294.4	397.8	9.7	8.5
Federal/provincial agreements	115.3	191.3	3.8	4.1
Research	185.4	335.3	6.1	7.1
Other	45.4	581.9	15.1	12.4
Total	*3,037.1*	*4,691.1*	*100.0*	*100.0*

[a]Includes resource conservation measures.

Note: Data refer to an average of expenditures in two crop years. For example, 1980–82 refers to an average of the 1980–81 and 1981–82 crop years.

Source: H. Garth Coffin, "Institutions, Instruments and Driving Forces in Canadian Agricultural Policies," in Kristen Allen, ed., *Proceedings of a Symposium on U.S.-Canadian Agricultural Trade Challenges, Minneapolis, July 22-24, 1987* (Washington, D.C.: Resources for the Future and the C.D. Howe Institute, forthcoming).

- farm credit;
- research and development; and
- inspection, quality control, and marketing programs.

Table 9 shows the various components of government agricultural spending in Canada for the 1980–82 and 1985–87 periods. Transportation subsidies, income stabilization, and production assistance are the largest spending categories. Overall, direct spending by provincial and federal governments was close to $6 billion in 1986, or roughly one-quarter of the value of farm cash receipts in that year and almost double the amount spent in the 1980–81 crop year.

Several characteristics of Canadian agricultural policy are worth noting.

First, provincial governments have increased their spending on agriculture substantially over the past ten years. Areas of active

provincial involvement are farm credit, input rebates, crop insurance, and direct production assistance to specific commodities such as livestock.

Second, there is heavy concentration on the grains sector. Grains account for 37 percent of farm cash receipts but represent a significantly greater proportion of government spending on agriculture, through programs such as the *Western Grain Stabilization Act* and the *Western Grain Transportation Act*. In 1982–83, grains and oilseeds accounted for 65 percent of federal commodity-specific expenditures.[22] This is undoubtedably higher today as a result of new spending initiatives aimed at these sectors.

Third, stabilization has given way to subsidization. A multitude of income stabilization and risk-management programs exist, administered by both levels of government. Problems in world markets have caused them to evolve into income subsidy schemes, often provided on an *ad hoc* basis.

Fourth, there is a distinct contrast between policies for the export sectors and those aimed at the nontraded sectors. While producers of exported commodities have not had the benefit of permanent programs to shield incomes in the face of severe market upset, farmers operating under supply management structures — in the egg, poultry, and milk industries — have been ensured high incomes, stable prices, and a minimum of competition.

The question arises as to whether the traditional objectives of agricultural policy and the instruments that have evolved to implement them are sufficient to handle the stresses currently facing the agriculture sector. Specifically, a great deal of emphasis has been placed on preserving the status quo, at the expense of objectives such as increasing competitiveness and improving the functioning of agricultural markets.

According to the 1986 census, there was only a 0.2 percent decrease in land in production during the 1981–86 period, a time of mounting world food surpluses and falling prices. Short-term financial assistance to farmers can exacerbate this situation if it is not properly structured. For example, deficiency payments to grain producers are based on acreage seeded, thus insulating producers from the reality of excess supply in the grain industry.

---

[22]Canada, Task Force Program Review, *Agriculture*, p. 166.

It has also been suggested that, in concentrating on keeping existing farmers in business, federal agricultural policies have neglected new entrants to the industry. Agriculture is now experiencing a "grey revolution" as the percentage of farmers over age 55 has reached its highest level since 1946. Meanwhile, the percentage of younger farmers — those age 35 and under — is declining.

It would seem that in the design of policy, greater emphasis should be placed on competitiveness, efficiency, and enhancing responsiveness to market forces. The traditional functions of Canadian agricultural policy no longer seem appropriate today.

A New Strategy for Canadian Agriculture

The problems facing the Canadian farm sector dictate that agriculture should form an important part of the national policy agenda in 1988. While the specific policy solutions required are beyond the scope of this *Policy Review and Outlook*, current realities suggest that greater weight be placed on the following in formulating strategies for the sector: market responsiveness, stabilization, competitiveness, and adjustment.

Market Responsiveness

A major failing of current agricultural programs is that they insulate producers from market realities and do not encourage the type of adjustment that would be in the best interests of the agricultural sector. In so doing, they also increase producers' dependence on government support. Increasing the responsiveness of the agricultural sector to market forces can be accomplished, in part, through the substitution of income deficiency payments with stabilization schemes and through reductions in agricultural trade barriers.

Although foreign trade barriers are something over which Canadians have little control, serious attention can be given to interprovincial barriers to trade. Examples abound of restrictive production, inspection, and marketing practices that raise producer costs, contribute to waste, and fragment an already small market. Even more serious is the recent escalation in direct provincial spending on agricultural programs, the effect of which, intentional or otherwise, is an increase in provincial market share at the expense of production elsewhere in Canada.

Provincial programs such as these are not greatly different from those to which Canada objects in international fora. Their effect is to distort the efficient allocation of inputs and production. They contribute to higher government expenditures, and, to the extent that they pit provincial treasuries against each other in attracting agricultural production, they amount to a very poor use of taxpayers' money.

Efforts should be made to dismantle other agricultural policies and practices that distort production and investment decisions. For example, the oversupply situation characterizing international grain markets should force policymakers to examine the wisdom of grain freight rate subsidies under the *Western Grain Transportation Act*. The effect of rail subsidies is to encourage the production of grain for export markets and to discourage the use of grain within Canada.[23] Critics of the present system, which include the Alberta government and livestock groups such as the Canadian Cattle Commission, charge that through raising feed grain prices on the Prairies, it works against the development of a viable beef and pork industry in Western Canada, an area in which that region should have a comparative advantage.

A system of direct payments to producers would allow more flexibility in grain marketing, in the mode of transport chosen, and in the commodities produced. This flexibility is critical if producers are to respond to today's market realities, which, in Canada's case, are likely to call for more than simply maximizing the production of grains for export markets.

Stabilization

An important priority of policy is the replacement of *ad hoc* measures of income support with more effective strategies to cushion farm incomes from market instability. In attempting to protect producer incomes, it should be recognized that some of the recent erosion in market returns is due to structural factors that have increased agricultural productivity globally. Governments, therefore, must resist the impulse to preserve the incomes of all existing farmers, since this would be denying the possibility that too many resources are concentrated in agriculture.

---

[23]J.C. Gilson, *Western Grain Transportation: Report on Consultations and Recommendations* (Ottawa: Supply and Services Canada, 1982).

Governments can however, share in the risk that arises from purely cyclical phenomena. An effective policy instrument would be an actuarially sound farm income stabilization program funded by governments and producers.[24] Such a system would explicitly "decouple" income support from production decisions so as not to encourage increased output in response to government subsidized returns. Instead of support on a per bushel, per head, or per acre tilled basis, which would provide an incentive to produce more to improve receipts, farmers would get a minimum return irrespective of current production levels. When markets are poor, returns should not be high enough to discourage either the planting of alternate crops or initiatives to decrease costs and increase efficiency. When markets are good, payments into the program should generate a surplus to be used in future downturns, yet provide farmers with an incentive to adjust production to meet stronger demand.

An income insurance or stabilization scheme would have several advantages. First, it would address directly the key problem facing agricultural producers, namely, that of income instability owing to market and production risk. It would replace an *ad hoc* system of government support, which requires frequent representations by agricultural leaders, with an impartial stabilization structure.

Second, it would not include assumptions about market realities that could cease to be relevant in the future. Agricultural demand and supply are inherently unstable, as past experience has shown. It is important, therefore, to resist programs exclusively geared to a situation of oversupply. By neither encouraging nor discouraging production but simply smoothing returns over market cycles, stabilization programs can respond to most market situations.

Third, in all likelihood, producer insurance or stabilization schemes would be acceptable in an international trading context. Key to ensuring that the programs are not seen as distorting trade are provisions that "decouple" income support from production decisions, and plans that are actuarially sound.

Fourth, since support would be "decoupled" from production decisions, it would allow producers to be more flexible in the commodities they produce, the inputs they use, and the marketing arrangements they adopt.

---

[24]For a discussion of the merits of stabilization programs and their consistency with international trade objectives, see T.K. Warley, "Issues Facing Agriculture in the GATT Negotiations," *Canadian Journal of Economics* (forthcoming).

Finally, government expenditure requirements would be reduced because the fund would be actuarially sound and because producer contributions would be required as well.

In contemplating the use of stabilization programs, policymakers should bear in mind that such programs can too easily evolve into income subsidy schemes. In fact, an argument could be made that this has occurred with the Western Grain Stabilization Plan over the past several years. Stabilization schemes do not handle well market changes of a noncyclical nature, and the risk exists that they could be used to accommodate situations of a more structural nature. Support levels should be "low strung" and the commitment to actuarial soundness should be firm to ensure that stabilization plans do not impede the movement of resources out of agriculture.

Competitiveness

Increasing the productivity and efficiency of the entire agrifood system is critical to Canada's continued success in world markets. Although competitiveness can be enhanced through technology, training, and other initiatives, it should be an important objective underlying all policies aimed at the agricultural sector.

Productivity can be further enhanced through training programs. The stereotype of the small family farming enterprise no longer holds true. Today's producers require expertise in management, accounting, and systems, skills which can be promoted through government-sponsored programs.

Effective arguments can also be made for increasing government funding for research and development. Regarding agricultural R&D generally, it has been claimed that these advancements tend to benefit the consumer, not the producer, since the benefits of lower production costs are passed on through lower commodity prices. However, to the extent that Canada has little impact on world commodity prices, research benefits would more likely accrue to farmers in the form of lower production costs. Research and development, combined with market research, will help Canada find the product niches that will enable it to compete internationally.

Adjustment

If the efficiency and flexibility of Canadian agriculture is to be increased, producers will need to make adjustments. As is the case

in most industrialized countries, Canada probably devotes too many of its resources to food production and would benefit from the transfer of some of these resources into other sectors of the economy. It is also possible that productive resources have been misallocated within the agricultural sector itself. Specifically, the emphasis placed on producing grain for export markets requires some reevaluation in light of the current state of world grain markets.

Policies that emphasize the important role of international and domestic market conditions in allocating resources and that reduce investment and production distortions will prompt adjustment in this sector. The adjustment could involve changes in the types of crops produced, in the production methods employed, or in the number of producers in the industry.

Adjustment often poses much more considerable problems for agricultural workers than for workers in most other sectors. Loss of farm employment can mean losing a place of residence, a community, and a way of life. Relocation and retraining assistance can ease the adjustments faced by those leaving agriculture, many of whom would not have had experience in other types of work. This would require a special recognition of and sensitivity to the specific needs of agricultural workers.

Concluding Comments

Agricultural adjustment is a pressing national issue. Major government initiatives in the area of tax reform and free trade offer few, if any, ways to solve the fundamental challenges facing the farm sector. Canadian farm policies are out of date, and are not equipped to handle the reality of saturated export markets and depressed prices. Income deficiency payments are not a viable long-term solution to what may turn out to be more than a cyclical decline in farm incomes, from the point of view of taxpayers or producers.

In formulating effective policies for the agricultural sector, governments should emphasize issues of market responsiveness and competitiveness. Adjustment is inevitable for Canadian agriculture, although some producers will find the changes difficult. Nevertheless, Canada has the potential to compete successfully in world food markets. The challenge will be to survive current market stresses and to use this potential to advantage when calmer conditions prevail.

4

Focus on Follow-through

Well begun is half done.

Aristotle

Canadian governments dealt effectively with an overloaded policy agenda in 1987. Free trade, tax reform, constitutional changes, agricultural problems, budget deficits, and turbulent financial markets overextended policymakers, but the results on most of these initiatives are surprisingly good, so far. On several of these fronts, however, more work is essential to complete and to improve on the initiatives of 1987.

In 1988, policymakers should focus on follow-through. The signing of the free trade deal, for example, in many ways marks the beginning — not the end — of the road. One stage of tax reform is already in place, but the second stage is an essential ingredient of the reform package and could prove more difficult in its execution. Agricultural policy needs overhauling to cope with new realities. Budget deficits have not come down far enough or fast enough. The overload of 1987 has eased, but much remains to be done in 1988 if current policy directions are to bear fruit.

This chapter, building on the analysis of previous chapters, lays out the policy follow-through that is needed in 1988. Before turning to the agenda, however, a word is needed on the likely economic environment in the coming year.

The Economic Environment

The economic watchwords for 1988 are volatility and caution. Volatility in world financial markets can be expected to continue, since coordinated policy solutions to international trade and budgetary imbalances are not on the horizon. The inadequate U.S. budget resolution reached in late 1987 does not bode well for a significant reduction in the U.S. budget deficit. And without U.S. leadership, West

Germany and Japan are unlikely to feel obligated to do more to spur growth of domestic demand in their economies.

In the absence of a coordinated solution, there is a significant risk that the conditions that precipitated the October 1987 stock market decline could reemerge. In particular, continuing bad news on the U.S. trade deficit, further weakening of the U.S. dollar, renewed inflationary fears, and rising interest rates could set off another chain reaction in financial markets.

The prospects for economic growth in the industrialized countries — and, by extension, in Canada — are hazy. The late 1987 consensus forecast of 2½ percent real growth is little more than an extrapolation of current trends. Even if the economy does register a 2½ percent year-over-year gain in real gross domestic product (GDP) in 1988, this will represent a considerable slowdown.[1] This should not be surprising given that the economic expansion in the industrialized countries is more than five years old — a relatively long expansion by postwar standards. The need for caution reflects the fact that the anticipated slowdown is a "no surprises" scenario, one that is surrounded by a wider than usual band of uncertainty.

Regardless of which economic forecast one chooses, the correction in the U.S. current account balance, discussed in Chapter 1, will likely begin in 1988. The longer the turnaround is postponed the more violent and potentially destructive it is likely to be. The best hope is that strengthening domestic demand in West Germany and Japan relative to the United States and delayed effects of the fallen U.S. dollar will bring about a benign turnaround. But a less favorable outcome, often referred to as the "hard landing", cannot be ruled out: namely, that the U.S. current account will turn around because of a sharp contraction in U.S. private consumption and investment. This outcome would cut U.S. imports and risk spreading recession throughout the industrialized countries.

The Policy Agenda

Policymakers need to be aware of these possibilities, and be prepared to deal with them. They should not, however, allow these possibilities to deter them from following through on sound domestic

[1]Measured on a fourth-quarter-over-fourth-quarter basis, current projections suggest that real GDP growth will slow from almost 5 percent in 1987 to just over 1 percent in 1988.

policy initiatives. In the remainder of this chapter, we outline the economic policy priorities for 1988. These include:

- implementing the free trade agreement;
- clarifying the federal government's strategy for facilitating adjustment to free trade;
- developing options for negotiating a new set of Canadian-U.S. trade laws;
- presenting a detailed proposal for sales tax reform;
- devising a new medium-term strategy for Canadian agricultural policy;
- keeping federal deficit reduction on track; and
- maintaining a monetary policy that balances concerns about inflation and the need to stabilize financial markets.

Implementing the Free Trade Agreement

Prime Minister Mulroney and President Reagan signed the Canada-U.S. Free Trade Agreement on January 2, 1988. The agreement will take effect on January 1, 1989, if all of the necessary implementing legislation has been passed by Parliament and by the U.S. Congress. Benefits from the agreement will begin to flow only when entrepreneurs and businesses are convinced that it will be implemented in both countries. In the meantime, uncertainty over the final outcome will delay new investments in Canada that depend on free trade opportunities. Thus, the highest priority on the federal government's agenda for 1988 is to ensure that Parliament passes the agreement.

Each country has its own legal requirements and its own timetable for ratifying the agreement. In the United States, the implementing legislation will be presented to Congress perhaps as early as March, although the chairmen of the House Ways and Means Committee and the Senate Finance Committee both indicated in late 1987 that they would prefer a later date to allow them to deal with other legislative issues. Once the implementing legislation is tabled, the House and the Senate will have 90 legislative days to consider it. Under the rules of the "fast-track" negotiating authority, congressional committees can hold hearings on the agreement; they cannot, however, make changes to the agreement — they must either accept it or reject it in the form it was agreed on by the prime

minister and the president. Depending on when the legislation is presented to Congress, the legislative approval period likely will expire in the summer or early autumn of 1988.

In Canada, the nature and format of the separate implementing legislation has not yet been determined. It is likely that the two countries' officials will coordinate the design of implementing legislation to ensure that it accurately reflects the intent of the agreement. The federal government could implement parts of the agreement through Orders in Council, but those parts that require changes in legislation will have to be passed in both the House of Commons and the Senate. Opposition in either chamber could delay the process.

The provinces also will be called on to implement changes in areas under their jurisdiction. Although only a small part of the agreement falls within their jurisdiction, and although some legal experts argue that the federal government has constitutional authority to force provincial compliance with international trade agreements it has negotiated, wrangling over changes within provincial jurisdiction could make implementation more difficult and time consuming. Furthermore, U.S. congressional committees are likely to keep a close eye on the process in Canada, since implementation snags here could alter their view of the agreement.

Recommendation 1: The federal government should focus its efforts on ensuring that all necessary steps are taken to implement the Canada-U.S. Free Trade Agreement expeditiously. Provincial governments should participate constructively in considering the necessary legislation to implement the agreement.

Adjustment Assistance

Free trade will require industrial rationalization and adjustment over the coming decade if Canada is to achieve maximum benefit from the agreement. While free trade will be an important source of adjustment pressures, we have noted in this *Policy Review and Outlook* that it is only one of many factors requiring firms and individuals to adjust. The coming turnaround in the U.S. trade balance, corporate tax reform, changes in world agricultural mar-

kets, the globalization of markets, continuing rapid technological change, and numerous other factors also will impose important adjustment pressures on the Canadian economy. The C.D. Howe Institute has argued in previous studies for the need to redesign labor market and industrial policies to encourage adjustment, rather than to discourage it as do many current policies.[2]

In the Institute's view, special attention now needs to be focused on adjustment assistance policies in light of the free trade agreement, for three reasons:

- First, the benefits of free trade should be used to cushion the impact on individuals in industries that are forced by free-trade-related competitive pressures to reduce employment levels.
- Second, although the Canadian economy has demonstrated significant capacity to adjust to changing economic circumstances in recent years, well-designed government programs can accelerate and improve the adjustment process by providing job information, retraining, and mobility assistance.
- Third, although numerous studies indicate that industrialized countries usually absorb adjustment to trade liberalization almost unnoticed, Canadian workers apparently harbor considerable fears of losing their jobs. These fears, which have been fanned by groups opposed to free trade,[3] could be relieved by the announcement of labor market policies designed to accelerate the reemployment of workers in vulnerable industries who lose their jobs as a result of free trade.

The federal government has not issued a clear message on what, if anything, it intends to do to facilitate adjustment to free trade.[4] There appears to be two reasons for this hesitancy. First, it is

[2]See Thomas J. Courchene, *Social Policy in the 1990s: Agenda for Reform*, Policy Study no. 3 (Toronto: C.D. Howe Institute, 1987); Richard G. Lipsey, *The Canada-U.S. Free Trade Agreement and the Great Free Trade Debate*, Trade Monitor no. 1 (Toronto: C.D. Howe Institute, November 1987); and Ronald J. Wonnacott with Roderick Hill, *Canadian and U.S. Adjustment Policies in a Bilateral Trade Agreement*, CAC no. 57 (Toronto; Washington, D.C.: Canadian-American Committee, 1987).

[3]See, for example, Presentation by the Canadian Labour Congress to the House of Commons Standing Committee on External Affairs and International Trade, December 4, 1987.

[4]At the First Ministers' Conference on November 18, 1987, Prime Minister Mulroney announced that the federal government had mandated the Canada Employment

(continued)

difficult to determine the extent to which free trade might be responsible for future job losses. Second, given the size of the federal budget deficit and the government's great difficulty in reducing it, the government is reluctant to introduce new labor market programs that would add to its expenditures.

In the Institute's view, these represent important constraints on the redesign of adjustment assistance programs. They do not, however, constitute a rationale for doing nothing.

There are two additional reasons why the government may feel it is unnecessary to undertake new initiatives. First, it is argued that although some workers will lose their jobs because of reductions in Canadian trade barriers, a greater number of jobs will be created — many within the same industry or even the same company — because of reductions in U.S. trade barriers. This argument implies that adjustment assistance for dislocated workers may be unnecessary since jobs will be plentiful.[5]

Second, it is argued that even if some workers will need adjustment assistance, existing programs can handle these people adequately.[6] Examples of such programs are unemployment insurance (UI); labor market information and counselling through Canada Employment Centres; job training through a range of federal training programs, including some which permit trainees to collect UI for up to two years, and community-based adjustment programs through the Community Futures program, which provides training and relocation assistance or seed money for individuals who wish to start their own business. While these programs represent an important base of adjustment assistance, the question remains: Could specially designed adjustment policies facilitate smoother adjustment, encourage a more equitable sharing of free trade's benefits, allay fears of job loss, and enhance the political efficacy of free trade? We believe the answer is yes, and that the free trade agreement creates an opportunity to improve Canada's adjustment assistance programs.

---

[4]Continued...
and Immigration Advisory Council to examine how existing government programs and services can be used to assist firms and workers to adjust to free trade and to recommend necessary changes by June 30, 1988.

[5]Wonnacott and Hill, *Canadian and U.S. Adjustment Policies*, p. 10.

[6]Hon. Benoît Bouchard, Remarks by the Minister of Employment and Immigration to the First Ministers' Conference, Toronto, November 18, 1987.

In the Institute's view, targeted adjustment programs should be designed to ease the adjustment for individuals in industries or communities that are demonstrably injured by free trade. As we indicated in Chapter 2, some manufacturing industries are likely to experience substantial pressures to rationalize to remain competitive within the free trade area. Some workers in these industries may have industry- or firm-specific skills that are not easily transferable. Others may be elderly and not in a position to retrain or relocate. Still others may be women who cannot move because of family circumstances. Some of these individuals could experience losses of income and reduced employment opportunities.

The national dividend from free trade should be used, in part, to provide equitable treatment of such individuals. We stress, however, that only a limited number of industries and communities actually will experience such dislocation. Certain conditions should be met — for example, a significant net tariff reduction in the industry, or a plant closure traceable to increased imports from the United States — before those that are adversely affected can qualify for assistance. Furthermore, in order to facilitate the rationalization that will produce improved productivity and competitiveness, adjustment assistance should focus on individuals rather than on firms. This approach offers the most potential for moving people into better, more secure jobs.

Would such an adjustment assistance program greatly increase the deficit? The answer depends entirely on its design. By raising national income, free trade should help reduce the federal deficit — by as much as $5 billion per year by 1995, according to one estimate.[7] It should be easy to finance a well-targeted adjustment assistance program — one that would deal with the most serious adjustment problems — for a fraction of this amount.

Recommendation 2: The federal government should design a targeted program of adjustment assistance for individuals demonstrably injured by free trade, to be implemented along with the free trade agreement on January 1, 1989.

---

[7]Sunder Magun, Someshwar Rao, and Bimal Lodh, *Impact of Canada-U.S. Free Trade on the Canadian Economy*, Economic Council of Canada Discussion Paper no. 331 (Ottawa: Economic Council of Canada, August 1987), p. 66.

Trade Laws

One disappointing feature of the free trade agreement is its failure to make progress in negotiating new trade laws to apply to bilateral trade. Although it goes some way toward managing bilateral trade disputes through its dispute settlement mechanism, the negotiators were unable to achieve the desired breakthroughs of defining a subsidies code and revising antidumping and countervailing duty laws. The two countries have agreed, however, to undertake their "best efforts" to negotiate new subsidy, countervail, and dumping laws over a five-year period, with a possible two-year extension.

In our view, the two countries failed to achieve an agreement on subsidies because of political difficulties that would have arisen *in both countries* in attempting to remove existing subsidies. While agreement to dismantle some forms of subsidies may be possible, we are not highly optimistic that major progress will be made on this front. Additional research is required to identify and build a professional consensus on the question of which subsidies and trade laws are actually trade distorting and which are not. We do feel, however, that sensible, mutually beneficial changes in countervail and antidumping laws are possible.[8] For example, within the free trade area, it would make sense to base all future countervailing duty rulings on the net subsidy between the two countries, rather than to examine only the defending country's subsidies as is the case under current law. It would also make sense to remove the damaging full-allocated-cost rule in antidumping law, a rule which prevents fair competition when industries are not operating near full capacity.

Recommendation 3: Canada's trade negotiators should press for an early start to negotiations on a new set of bilateral trade laws and seek mutually beneficial changes to countervail and antidumping laws well ahead of the five-year deadline. At the same time, the federal government should support research by trade specialists, lawyers, and economists on the degree to which different types of subsidies influence or distort trade

[8]For a detailed discussion, see Murray G. Smith with C. Michael Aho and Gary N. Horlick, *Bridging the Gap: Trade Laws in the Canadian-U.S. Negotiations*, CAC no. 53 (Toronto; Washington, D.C.: Canadian-American Committee, 1987).

and on the options for revising trade laws within the Canada-U.S. Free Trade Agreement.

Tax Reform

In its *White Paper on Tax Reform*, the federal government proposed the most comprehensive overhaul of Canada's tax system since the Carter Commission reported in 1966.[9] While the general thrust of the reform package — lowering tax rates, broadening tax bases, and shifting the tax burden from income taxes to consumption taxes — was in the right direction, the *White Paper* was a disappointment for several reasons:

- it separated the reform into two stages and, by delaying the reform of the sales tax, it left the most important reforms for the indefinite future and increased the chances that electoral politics will scuttle the second stage;
- it raised marginal tax rates for individuals and families in the middle-income range — $27,500 to approximately $43,000 — and because of the way it converted tax deductions into credits, it increased the tax burden on many middle-income families with children;[10]
- it substantially increased the taxation of investment income by providing less than complete integration of the personal and corporate income taxes and by raising the effective rate of capital gains tax while not allowing for inflation adjustment.

In spite of these disappointments, the implementation of the first-stage reforms, as defined in the legislation that Finance Minister Wilson presented on December 16, 1987, represents a significant step toward a fairer and more neutral tax system with lower tax rates. The legislation corrects some of the anomolies of the *White Paper* proposals and provides the basis for the critical second stage of reform. As we pointed out in Chapter 2, the second-stage reforms,

[9]For an analysis of this document, see Edward A. Carmichael, ed., *Tax Reform: Perspectives on the White Paper*, Policy Study no. 4 (Toronto: C.D. Howe Institute, 1988).

[10]The increased tax burden on middle-income families with children was reversed by changes contained in the tax reform legislation tabled by Finance Minister Michael Wilson on December 16, 1987 (see Hon. Michael H. Wilson, *Tax Reform 1987* [Ottawa, December 16, 1987], pp. 2–3).

which include replacement of the manufacturers' sales tax (MST) with a broadly based, multistage sales tax, promises to have a substantial positive impact on the economy in general and on a number of manufacturing industries that could face pressures from free trade and corporate tax reforms.

The second-stage reforms should be revenue neutral, and should contain the following elements:

- the replacement of the MST with a value-added tax (VAT) covering most goods and services;
- the enhancement of the refundable sales tax credit to offset fully the regressive impact of the VAT on low-income taxpayers;
- the elimination of the personal and corporate surtaxes that were introduced in the May 1985 budget;
- the reduction of middle-income marginal tax rates by adjusting downward the middle rate of the current 17-26-29 percent rate structure; and
- the phased introduction of inflation indexation into both the personal and corporate income tax systems.

Two specific considerations require further elaboration. First, the federal government is currently consulting with the provinces on the feasibility of implementing a national sales tax that would also involve replacing provincial sales taxes with a broadly based VAT. Initial responses from the provinces range from outright rejection (Alberta) to demands for exemptions for provincial and municipal government services (Ontario). In the Institute's view, while the consultations are necessary and valuable, if provincial interest and consensus does not appear to be forthcoming by mid-1988, the federal government should proceed quickly with a federal-only VAT.

Second, the major obstacle to sales tax reform is the politically sensitive issue of whether to include food and other necessities in the tax. Economic analysis clearly shows that including food and adding a generous sales tax credit would allow a lower sales tax rate and would be more beneficial to low-income families, who spend a relatively large proportion of their budget on food. Economic studies also show, however, that the main benefits of sales tax reform can be attained without taxing food. A pragmatic and economically sound approach — and the one that Finance Minister Wilson an-

nounced he intends to follow — is to exempt food and prescription drugs in order to build public support for sales tax reform. The exclusion of these items would permit other sensible exclusions such as financial intermediation services — which are not included in value-added taxation in any other country. It should not, however, be allowed to open a flood gate of requests for special exemptions from the new sales tax.

Recommendation 4: The federal government should present a detailed sales tax reform proposal in 1988 as part of a revenue neutral second-stage tax reform. The federal government should be prepared to go it alone on sales tax reform if provincial cooperation is not readily forthcoming.

Agricultural Policy[11]

At the Venice Summit of June 1987, the Canadian government argued that agricultural support programs play an important role in the global imbalances characterizing the world economy. Large increases in agricultural subsidies have contributed to budgetary deficits, which, in the case of the United States, must be financed through foreign borrowing. Developing countries' debt problems are also exacerbated by agricultural programs undertaken by the industrialized countries. In addition to reduced revenues from their exports, depressed prices have meant less incentives for the developing countries to produce domestically and a greater dependence on food imports from the industrialized countries.

Arguments for reductions in agricultural support levels, therefore, extend beyond the damage they inflict on international food markets. The need to reduce budget deficits, current account imbalances, and debt problems also provides powerful reasons for subsidy reduction.

Despite these incentives, the political dynamics involved, both domestically and on a multilateral level, suggest that multilateral reductions in agricultural subsidies will be a complex and tedious

[11]The Institute will be publishing two studies that examine agricultural issues in more depth. See Kristen Allen, ed., *Proceedings of a Symposium on U.S.-Canadian Agricultural Trade Challenges, Minneapolis, July 22-24, 1987* (Washington, D.C.: Resources for the Future and the C.D. Howe Institute, forthcoming); and J.C. Gilson, *Global Challenges in Agriculture: Implications for Canada*, Policy Study no. 5 (Toronto: C.D. Howe Institute, forthcoming).

process. As a relatively small producer and a minor offender as far as agricultural support is concerned, Canada cannot take a leadership role in subsidy reduction. It can, however, continue to press for realistic solutions to the problem of escalating agricultural subsidies, both within the General Agreement on Tariffs and Trade (GATT) and in the international arena outside the GATT. In the design of domestic agricultural policy, Canada can also look to agricultural support strategies that do not distort food trade and, therefore, would be considered acceptable in an international context.

Domestic agricultural policy has become reactive over the past five years due to the impact of international market conditions on Canadian agricultural revenues. Financial relief for farmers is something few Canadians would dispute, despite substantial increases in farm spending in recent years. This does not mean, however, that Canadian taxpayers will continue to support large income transfers to farmers indefinitely, or that support for farmers could not be provided in more effective ways.

While Canadian agricultural policy needs to be reassessed in the light of the changed world environment, policymakers have little room for maneuver. Strategies can be formulated, however, to bring the agricultural sector more in line with current market realities. In the design of specific policies, greater emphasis should be placed on making production decisions more responsive to world market conditions and on improving competitiveness. Less emphasis should be devoted to maintaining the status quo in incomes, products, and markets. The immediate concern of agricultural policy over the past two years has been to ease the financial plight of farmers, particularly those in the grains sector. *Ad hoc* income programs, such as those currently in place, could lead to even more substantial expenditures if market conditions worsen. They are also highly vulnerable to lobbying activity aimed at securing similar or better programs for other commodity groups. Producers and taxpayers would be better served by stabilization programs designed to smooth producer incomes over the inevitable market cycles.

Support policies, however, should not discourage needed adjustment in Canadian agriculture. Adjustment is as inevitable for agriculture as it is for other sectors of the economy, although it can pose great problems for the agricultural producer.

Issues of competitiveness and efficiency have taken a back seat in recent years to concerns about farm finances and survival. Many

of the factors contributing to the excess supply in world food markets are structural in nature. Governments need to review their agricultural objectives and policies to ensure that they respond to the new realities in international markets. At the same time, they should strive to change these realities, whenever possible, through actions in the multilateral arena.

Recommendation 5: The federal government should continue to press for solutions to the agricultural subsidy war among major producing countries, both in the Uruguay Round of GATT negotiations and in other international fora. At home, federal and provincial governments should place high priority on developing longer-term strategies for dealing with the changes in world agricultural markets. These strategies should place greater emphasis on making farm production decisions more responsive to changes in world market conditions and less emphasis on maintaining the status quo.

Public-Sector Deficit Reduction

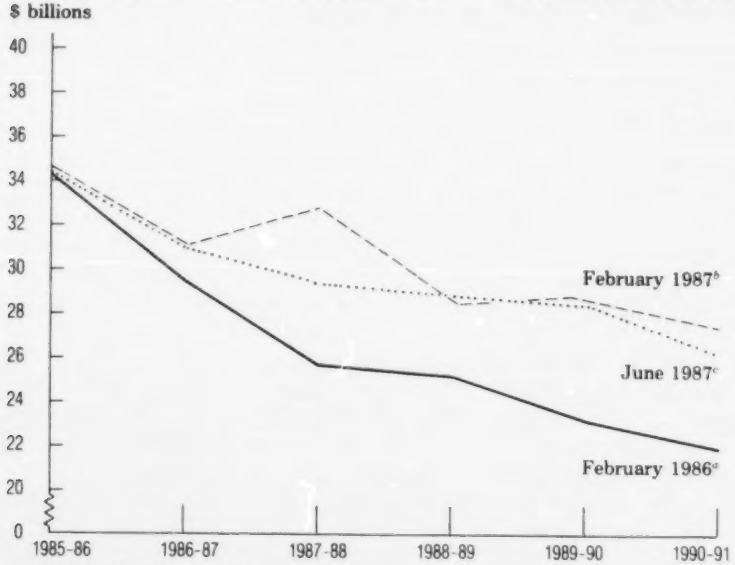
The federal government set budget deficit reduction as one of its highest priorities shortly after being elected. When Finance Minister Michael Wilson tabled the government's economic strategy in November 1984, he warned that:

> Continued high deficits and growing debt will increasingly undermine confidence, put upward pressure on interest rates and reduce prospects for growth. Moreover, they increasingly constrain the federal government's ability to discharge its responsibilities for overall economic management and effective economic leadership.[12]

The warning is as valid in 1988 as it was in 1984. Early in its mandate, the federal government made good progress in cutting the deficit by adopting a number of controversial cuts in federal spending. In its February 1986 budget, it took further significant steps to cut spending and raise revenues. The *Fiscal Plan* contained in the February 1986 budget projected that, with no further expenditure or tax changes, the budgetary deficit would fall from its peak

[12]Hon. Michael H. Wilson, *A New Direction for Canada: An Agenda for Economic Renewal* (Ottawa: Department of Finance, November 1984), p. 19.

Figure 7
Federal Deficit Projections, fiscal years 1985–86 to 1990–91



[a]Based on February 1986 *Fiscal Plan*.
[b]Excluding February 1987 budget measures.
[c]Including February 1987 budget measures and the first-stage tax reform measures.

Source: C.D. Howe Institute, based on Department of Finance, *The Fiscal Plan* (Ottawa, February 1986); idem, *Budget Papers* (Ottawa, February 1987); and idem, *Economic and Fiscal Outlook* (Ottawa, June 1987).

of $38 billion in fiscal year 1984–85 to $22 billion by fiscal year 1990–91. The government also projected that such a cut in the deficit would achieve a major fiscal objective: the growth of the federal debt would slow down so that it would no longer exceed the growth of the economy by fiscal year 1990–91.

After the sharp drop of oil and grain prices in early 1986, the momentum of deficit reduction slackened. Just prior to the February 1987 budget, the outlook for the federal deficit had worsened by over $6 billion for fiscal year 1987–88 and by about $5 billion per year for the next three fiscal years, as shown in Figure 7. In the February 1987 budget, the government managed to cut

$2.4 billion from the 1987–88 deficit mainly by accelerating tax payments and by slowing down some defense and foreign aid expenditures. The June 1987 tax reform proposals were then designed to be "deficit neutral" and the new fiscal plan that accompanied the *White Paper* projected that the deficit would barely creep below $30 billion in fiscal years 1987–88 through 1989–90.[13]

Canadians should be concerned about the stalled momentum in cutting the deficit. In March 1982, the federal public debt was $100 billion, or 25 percent of GDP. By mid-1988, following a string of annual deficits exceeding $30 billion per year, the federal debt will hit $300 billion, or 55 percent of GDP. This huge debt is an albatross around the government's neck. In the fiscal year ending March 1988, the government projected that it would have to pay out $28.5 billion, or 30 cents out of every dollar of federal revenue, in interest on the public debt. Public debt interest payments are now by far the largest government expenditure — more than the government spends on pensions ($14.5 billion), national defense ($10.5 billion), or unemployment insurance ($10 billion).

The debt poses a major danger for the Canadian economy. In the event of an increase in international interest rates, which are entirely outside Canadian control, federal spending to service the debt automatically rises. At the current and projected levels of the debt, every one percentage point increase in interest rates will increase interest payments (and the deficit) by $2–3 billion per year. The huge debt also means that, in the event of a major recession, the federal government would have very little room to maneuver to implement countercyclical tax or expenditure measures.

The continuing growth of the public debt poses another problem. As financing requirements to fund private investment rise, without an appreciable decline in public-sector borrowing requirements, Canadian financing requirements increasingly must be met by borrowing abroad, as was clearly shown in Figure 1. As Canadian private savings have diminished during the past two years, the collision of private and public borrowing requirements has necessitated a record capital inflow. Much of the inflow has financed private investment and has contributed to a rising trend in Canada's

[13]For a more detailed discussion of the deficit-neutral approach to tax reform, see Edward A. Carmichael, "Tax Reform: The Impact on Government Finances," in Carmichael, ed., *Tax Reform: Perspectives on the White Paper.*

foreign indebtedness and in the foreign ownership of Canadian industry.

For these reasons, Canadians should continue to be concerned about the federal budget deficit. A faster reduction in the deficit than is currently planned is clearly desirable. Sizable reductions in the deficit — $4–5 billion per year over the next three years — would be a major step toward a more sustainable, less risky fiscal stance. Yet such cuts appear to be unlikely given recent expenditure commitments and the nearness of the next federal election.

Pressures for increased spending are immense. To deal with the problems in agriculture, the Minister of Agriculture announced, in December 1987, $2.8 billion in deficiency payments and other assistance to farmers. To provide increased assistance for childcare, the Minister of National Health and Welfare announced an $800 million per year program. To meet the objectives of the *White Paper on National Defence*, the Minister of National Defence announced his intention to undertake a major increase in defense spending on new equipment, including expensive nuclear submarines. As the election approaches, other ministers will undoubtedly contemplate new projects aimed at winning votes in marginal ridings.

These pressures present Finance Minister Michael Wilson with a major dilemma. With the possibility of a slower-growing economy, yet with little relief in interest rates in 1988, it may prove difficult to keep the deficit down to even the unacceptably high $29 billion level projected for 1988–89 in the fiscal plan that accompanied the *White Paper on Tax Reform*. To reach this target, or to aim for an even lower deficit, could then mean yet another round of tax increases. Responsibility for these tax increases, if they materialize, should be laid at the proper doorstep — that of the Cabinet and the big-spending ministries.

An economically sensible budget in early 1988 would be one that takes direct aim at federal spending. It would allow for only a marginal increase in nonstatutory programs, which currently account for about $40 billion of federal spending; it would invoke a temporary reduction in the rate of increase of transfer payments to families with above-average incomes; and it would freeze industrial subsidies. The government also should seriously consider accelerating the pace of privatization. Asset sales provide only a one-time increase in revenues. But if they can enhance the productivity and

growth of the industrial sector, the government should move ahead and use the revenue windfall to lower the deficit temporarily.

Only when all cost-effective options for expenditure reduction have been exhausted should the government resort to increasing taxes. Should tax increases be necessary, however, they should come in the form of straightforward rate increases on broadly based taxes, since this approach shares the burden of deficit reduction as broadly as possible. Hidden, distortionary tax increases should be avoided.

Recommendation 6: The federal government should not give up on its efforts to bring about substantial year-over-year reductions in the federal deficit as the next election nears. In light of recent expenditure commitments, it appears as though the government will have difficulty even holding the deficit below $30 billion. In the February 1988 budget, the government, in attempting to maintain deficit-reduction momentum, should exhaust every cost-effective option for expenditure restraint before resorting to a tax increase. If a tax increase is necessary, it should be a straightforward rate increase in the personal or sales tax.

Monetary Policy

As the economy enters a potentially volatile year, the federal government is like a boxer with one hand tied behind his back. For reasons just described, fiscal policy is impotent as a tool of economic stabilization. (This was exactly the outcome the Institute warned against as early as 1984 when it called for a credible medium-term deficit reduction plan.)[14] The only macroeconomic tool left is monetary policy.

Yet monetary policy, too, is constrained. Throughout 1987, the Bank of Canada warned that inflationary pressures must be kept in check. In his first major speech, the new Governor of the Bank, John Crow, stressed the need to pursue continuously the objective of price stability.[15] To pursue this goal, the Bank wisely tightened monetary policy in the summer of 1987.

---

[14]See Edward A. Carmichael, *Tackling the Federal Deficit*, Observation no. 26 (Toronto: C.D. Howe Institute, 1984), p. 6.

[15]John Crow, "The Bank of Canada and Its Objectives" (Speech to the Canadian Club, Toronto, April, 6, 1987).

In the immediate aftermath of the stock market correction, it appeared to many that inflationary pressures would recede. Although there were signs that the economy was slowing in the final quarter of 1987, the need to keep a close watch on inflationary pressures remains. The Bank of Canada provided a substantial injection of liquidity in October 1987 to help stabilize stock markets and shore up confidence. This intervention was necessary, well executed, and coordinated with other central banks. Yet this boost to liquidity posed the risk of adding to inflationary pressures. In the weeks and months following October 19, the Bank gradually drained excess liquidity from the system. This episode indicates how important a pragmatic approach to monetary policy is when financial markets are volatile.

Recommendation 7: The Bank of Canada should keep a close watch out for the reemergence of inflationary pressures in 1988. Containing these pressures early is the best approach to making progress toward lower interest rates. At the same time, if disruptions recur in international financial markets, the Bank of Canada, in concert with central banks in the other major industrialized countries, should provide liquidity as required, to restore confidence and to reduce the possibility of a serious economic downturn.

Conclusion

In economic policymaking, as in many of life's endeavours, achieving success depends on following through on initiatives. In golf, for example, the stance, the backswing, and the striking of the ball are all important elements of a good shot. But it is the follow-through that determines whether the ball will fly straight down the fairway or curve off into the rough.

Nineteen eighty-seven was a year of promising economic policy initiatives. The agenda for those who formulate, design, or negotiate new policy directions was a full one. Positive steps were taken toward securing a Canada-U.S. Free Trade Agreement and toward a beneficial reform of Canada's tax system.

If these 1987 initiatives and those of previous years, including the commitment to achieve substantial reductions in the federal bud-

get deficit, are to be successful, 1988 must be a year in which policymakers and legislators focus on follow-through. As we have pointed out, considerable skill and persistence will be required to ensure that the trade agreement is implemented expeditiously so that Canadians can plan with greater certainty to make the adjustments necessary to achieve the potential benefits. Follow-through on free trade in 1988 also should involve formulation of a targeted adjustment assistance program to facilitate the transition to free trade and the formulation of Canadian objectives and options for negotiating new antidumping and countervailing duty laws covering Canadian-U.S. trade.

In similar fashion, obtaining the full benefits of tax reform will require an early statement of the federal government's intentions with respect to reform of the federal sales tax. As a complement to its tax reform initiative, the federal government should follow through on an earlier commitment by demonstrating in the February 1988 budget its intention to achieve further significant reductions in the federal budget deficit.

Agriculture is a troubled sector of the Canadian economy, and the free trade and tax reform initiatives do not address its problems. Oversupply in world markets, largely due to large agricultural subsidies in the industrialized countries, but also the result of increased global agricultural productivity and slow demand growth, is the new reality facing Canadian agriculture. Policy initiatives to deal with Canadian agriculture's problems have been *ad hoc*. In 1988, federal and provincial governments should begin to follow up short-term responses by devising a more coherent longer-term strategy for Canadian agricultural policy.

The year ahead promises to pose new challenges to policymakers as they complete earlier initiatives and begin work on some important longer-term policy objectives. Volatility in the economic environment is likely to continue in 1988, meaning that the Bank of Canada will have a key role to play in navigating the difficult passage between renewed inflationary risks and financial market instability. It will not be an easy year for Canada, but if policymakers focus on follow-through, the prospects for the 1990s will be considerably brighter.

Bibliography

Allen, Kristen. Ed. *Proceedings of a Symposium on U.S.-Canadian Agricultural Trade Challenges, Minneapolis, July 22-24, 1987.* Washington, D.C.: Resources for the Future and the C.D. Howe Institute, forthcoming.

Bank for International Settlements, *Fifty-Seventh Annual Report.* Basle, June 1987.

Bergsten, C. Fred. "Economic Imbalances and World Politics," *Foreign Affairs* 65 (Spring 1987).

Canada. Department of Finance. *The Corporate Income Tax System: A Direction for Change.* Ottawa, May 1985.

_____. Department of Finance, *Tax Reform 1987: Economic and Fiscal Outlook.* Ottawa, June 1987.

_____. Statistics Canada, *Exports: Merchandise Trade 1986*, Cat. no. 65-202. Ottawa, 1987.

_____. Statistics Canada. *Farm Net Income, 1986*, Cat. no. 21-202 Ottawa, 1987.

_____. Task Force on Program Review. *Agriculture, A Study Team Report* Ottawa: Supply and Services Canada, 1986.

Carmichael, Edward A. *Tackling the Federal Deficit*, Observation no. 26. Toronto: C.D. Howe Institute, 1984.

_____. Ed. *Tax Reform: Perspectives on the White Paper*, Policy Study no. 4. Toronto: C.D. Howe Institute, 1988.

Courchene, Thomas J. *Social Policy in the 1990s: Agenda for Reform*, Policy Study no. 3. Toronto: C.D. Howe Institute, 1987.

Cox, David, and Harris, Richard G. "A Quantitative Assessment of the Economic Impact on Canada of Sectoral Free Trade with the United States," *Canadian Journal of Economics* 19 (August 1986): 377-394.

Crandall, Robert. "The Effects of U.S. Trade Protection for Autos and Steel," *Brookings Papers on Economic Activity* 1 (1987): 271-288.

Curzon Price, Victoria. *Free Trade Areas, the European Experience: What Lessons for Canadian-U.S. Trade Liberalization?*, Observation no. 31. Toronto: C.D. Howe Institute, 1987.

Dornbusch, Rudiger. "External Balance Correction: Depreciation or Protection," *Brookings Papers on Economic Activity* 1 (1987): 249–269.

Feldstein, Martin. "Correcting the Trade Deficit," *Foreign Affairs* 65 (Spring 1987): 795–806.

Forbes, J.D.; Hughes, R.D.; and Warley, T.K. *Economic Intervention and Regulation in Canadian Agriculture*. Ottawa: Economic Council of Canada and the Institute for Research on Public Policy, 1982.

Frank, James G. "Sixth Year of Expansion in the Cards," *Canadian Business Review*, Autumn 1987, pp. 4–7.

Gilson, J.C. *Global Challenges in Agriculture: Implications for Canada*, Policy Study no. 5. Toronto: C.D. Howe Institute, forthcoming.

_____. *Western Grain Transportation: Report on Consultations and Recommendations*. Ottawa: Supply and Services Canada, 1982.

Hamilton, Bob, and Whalley, John. "Efficiency and Distributional Effects of the Tax Reform Package." In Canadian Tax Foundation. *Proceedings of a Conference on the Economic Impacts of Tax Reform*. Toronto: Canadian Tax Foundation, forthcoming.

Harris, Richard G., with David Cox. *Trade, Industrial Policy, and Canadian Manufacturing*, Ontario Economic Council Research Studies no. 31. Toronto: Ontario Economic Council, 1983.

Hathaway, Dale. *Agriculture and the GATT: Rewriting the Rules*. Washington, D.C.: Institute for International Economics, 1987.

Helliwell, John F.; MacGregor, Mary E.; and Padmore, Tim. "Economic Growth and Productivity in Canada, 1955–90." In Sargent, John. Ed. *Economic Growth: Prospects and Determinants*, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada no. 22. Toronto: University of Toronto Press, 1985.

Hufbauer, Gary. "Comments and Discussion." *Brookings Papers on Economic Activity* 1 (1987): 337–345.

International Monetary Fund, *World Economic Outlook: Revised Projections*. Washington, D.C.: IMF, October 1987.

Jobin, Jacques. *Farm Instability on the Prairies*, Economic Council of Canada Discussion Paper no. 273. Ottawa: Economic Council of Canada, 1985.

Krugman, Paul, and Baldwin, Richard. "The Persistence of the U.S. Trade Deficit," *Brookings Papers on Economic Activity* 1 (1987): 1–56.

Lawrence, Robert, and Litan, Robert. "The Protectionist Prescription: Errors in Diagnosis and Cure" *Brookings Papers on Economic Activity* 1 (1987): 289–310.

Lipsey, Richard G. *The Canada-U.S. Free Trade Agreement and the Great Canadian Trade Debate*, Trade Monitor no. 1. Toronto: C.D. Howe Institute, November 1987.

_____, and Smith, Murray G. *Global Imbalances and U.S. Policy Responses: A Canadian Perspective*, CAC no. 55. Toronto; Washington, D.C.: Canadian-American Committee, 1987.

_____, and Smith, Murray G. *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation no. 27. Toronto: C.D. Howe Institute, 1985.

MacLeod, L.W. "The Competitive Position of the Canadian Slaughter and Processing Industry." In Canada. Department of Agriculture. *Proceedings of the Canadian Agricultural Outlook Conference, December 1986.* Ottawa, 1986.

Magun, Sunder; Rao, Someshwar; and Lodh, Bimal. *Impact of Canada-U.S. Free Trade on the Canadian Economy*, Economic Council of Canada Discussion Paper no. 331. Ottawa: Economic Council of Canada, August 1987.

Marris, Stephen. *Deficits and the Dollar: The World Economy at Risk*, Policy Analyses in International Economics no. 14. Washington, D.C.: Institute for International Economics, 1985.

Ministers Responsible for Agriculture. *A National Agriculture Strategy: Report on the Challenges Facing Agriculture.* Submitted to the Annual Conference of First Ministers, Vancouver, 1986.

Morgan Guaranty Trust Company of New York. "Global growth and adjustment at risk," *World Financial Markets*, September/October 1987.

Organisation for Economic Co-ordination and Development, *Economic Outlook* (June 1987).

_____. *National Policies and Agricultural Trade*. Paris: OECD, 1987.

Paarlberg, Robert L. *Fixing Farm Trade: Policy Options for the United States*, The Council on Foreign Relations Series on International Trade. Cambridge, Mass: Ballinger, 1988.

Peterson, Peter G. "The Morning After," *The Atlantic Monthly*, October 1987.

Rao, P.S., and Preston, R.S. *Inter-factor Substitution and Total Factor Productivity Growth: Evidence from Canadian Industries*, Economic Council of Canada Discussion Paper no. 242. Ottawa: Economic Council of Canada, September 1983.

Schiff, Maurice W. *An Econometric Analysis of the World Wheat Market and Simulation of Alternative Policies, 1960–80*, ERS Staff Report. Washington, D.C.: U.S. Department of Agriculture, International Economics Division, 1985.

Smith, Murray G. "Redefining Subsidies in U.S. Countervailing Duty Law: New Hazards for Canada," *International Economic Issues* (Institute for Research on Public Policy), September 1987, pp. 17–21.

_____, with Aho, C. Michael, and Horlick, Gary N. *Bridging the Gap: Trade Laws in the Canadian-U.S. Negotiations*, CAC no. 53. Toronto; Washington, D.C.: Canadian-American Committee, 1987.

Stein, Herbert. "A Primer on the Other Deficit," *AEI Economist* (March 1987).

United States. Congress. Congressional Budget Office. *The Economic and Budget Outlook: An Update*. Washington, D.C., August 1987.

Warley, T.K. "Issues Facing Agriculture in the GATT Negotiations," *Canadian Journal of Economics* (forthcoming).

Whalley, John. "'Trade, Industrial Policy, and Canadian Manufacturing'" by Richard G. Harris (with the assistance of David Cox): A Review Article," *Canadian Journal of Economics* 17 (May 1984): 386–398.

_____, and Trela, Irene. *Regional Aspects of Confederation*, Collected Research Studies of the Royal Commission on the Economic Union and Development Prospects for Canada no. 68. Toronto: University of Toronto Press, 1986.

Wilson, Hon. Michael H. *A New Direction for Canada: An Agenda for Economic Renewal*. Ottawa: Department of Finance, November 1984.

_____. *Tax Reform 1987*. Ottawa, December 16, 1987.

Wirick, R.G. "Managing Canadian Energy Demand and Supply." In Carmichael, Edward A., and Herrera, Corina M. Eds. *Canada's Energy Policy, 1985 and Beyond*. Toronto: C.D. Howe Institute, 1984.

Wonnacott, Paul. *U.S. and Canadian Automotive Policies in a Changing World Environment*, CAC 56. Toronto; Washington, D.C.: Canadian-American Committee, 1987.

Wonnacott, Ronald J., with Hill, Roderick. *Canadian and U.S. Adjustment Policies in a Bilateral Trade Agreement*, CAC 57. Toronto; Washington, D.C.: Canadian-American Committee, 1987.

World Bank. *World Development Report 1986*. New York: Oxford University Press, 1986.

Members of the C.D. Howe Institute*

ABN Bank Canada
A.G.F. Management Limited
Aberford Resources Ltd.
Abitibi-Price Inc.
Aetna Canada
Agropur, Coopérative Agro-Alimentaire
Air Canada
The Alberta Stock Exchange
Alcan Aluminium Limited
Alliance compagnie mutuelle d'assurance-vie
Amoco Canada Petroleum Company Ltd.
Miller Ayre
BC Sugar Refinery, Limited
BP Canada Inc.
Banca Commerciale Italiana of Canada
Robert A. Bandeen
Bank of Montreal
The Bank of Nova Scotia
La Banque d'épargne de la cité et du district de Montréal
Banque fédérale de développement
Banque Nationale du Canada
Barclays Bank of Canada
Giovanni Bastreri
Bata Limited
Baton Broadcasting Incorporated
Bell Canada
Bell Canada Enterprises Inc.
Roy Bennett
Beutel, Goodman & Company Ltd.
R.W. Billingsley
Birks Family Foundation
Bombardier Inc.
Bourse de Montréal
Bramalea Limited
Brascan Limited
Albert Breton
Budd Canada Inc.
Burns Fry Limited
CAE Industries Ltd.
The CSL Group Inc.
The Cadillac Fairview Corporation Limited
Caisse centrale Desjardins du Québec
Gordon R.W. Campbell
Campbell Soup Company Ltd.
Canada Colors and Chemicals Limited
Canada Development Corporation
The Canada Life Assurance Company
Canada Packers Inc.
Canada Trust
Canadian Bankers' Association
Canadian Corporate Funding Ltd.
Canadian Export Association
Canadian Federation of Agriculture
Canadian Federation of Independent Business
Canadian Hunter Exploration Ltd.
Canadian Imperial Bank of Commerce
Canadian Life & Health Insurance Association
Canadian Manufacturers' Association

*The views expressed in this publication are those of the authors and do not necessarily reflect the opinions of the members of the Institute.

Canadian National
Canadian Pacific Limited
Canadian Pulp & Paper Association
Canadian Tire Corporation, Limited
Canterra Energy Ltd.
Cargill Limited
Cavendish Investing Ltd.
The Chase Manhattan Bank of Canada
Chemical Bank of Canada
Ciba-Geigy Canada Ltd.
Citibank Canada
Kenneth H.J. Clarke
Clarkson Gordon
Commercial Financial Corporation Limited
Confederation Life Insurance Company
Consolidated-Bathurst Inc.
Consumers Gas
Continental Can Canada Inc.
Coopers & Lybrand
Corporation du Groupe La Laurentienne
Coscan Development Corporation
Pierre Côté
J.G. Crean
Crédit Lyonnais Canada
Crédit Suisse Canada
Crestbrook Forest Industries Ltd.
John Crispo
Hugh A. Curtis
Cyanamid Canada Inc.
Shirley Dawe
John Deere Foundation
Derlan Industries Ltd.
Desjardins, Ducharme, Desjardins & Bourque
Robert Després
John Dickey
Dofasco Inc.
Dome Mines Limited
Dome Petroleum Limited
The Dominion of Canada General Insurance Company
Dominion Securities Limited
Dominion Textile Inc.
Grant Dominy
Domtar Inc.
Dow Chemical Canada Inc.
Claude Dupont
Du Pont Canada Inc.
Edper Investments
Eldorado Resources Limited
The Empire Life Insurance Company
Tex Enemark
Energy & Chemical Workers Union
H.E. English
Falconbridge Limited
Ronald J. Farano
Federal Industries Ltd.
Fiberglas Canada Inc.
Fiducie du Québec
Fiducie Prêt et Revenu
Field & Field
Finning Tractor & Equipment Company Limited
First Boston Canada
Ford Motor Company of Canada, Limited
Formula Growth Limited
Four Seasons Hotels Limited
Donald T. Fudge
Gaz Métropolitain, Inc.
Gendis Inc.
General Electric Canada Inc.
General Motors of Canada Limited
James Gillies
Great Lakes Forest Products Limited
The Great-West Life Assurance Company
Morton Gross
Le Groupe CGI Inc.
Le Groupe Commerce, compagnie d'assurances
Groupe DMR Inc.
Le Groupe RO-NA Inc.
Groupe Sobeco Inc.
Groupe Transcontinental
Guaranty Trust Company of Canada
Gulf Canada Limited
C. Malim Harding
J.-P. Hétu

Hewlett-Packard (Canada) Ltd.
Honeywell Limited
Hongkong Bank of Canada
Howe International
Hydro-Québec
IBM Canada Ltd.
Imasco Limited
The Imperial Life Assurance Company of Canada
Imperial Oil Limited
Inco Limited
Inter-City Gas Corporation
International Brotherhood of Electrical Workers
Interprovincial Pipe Line Limited/Home Oil Company Limited
The Investors Group
John A. Jacobson
Jocelyn Jacques
Jarislowsky, Fraser & Company
Kerr Addison Mines Limited
Kraft Limited
John Labatt Limited
Lac Minerals Ltd.
Lake Ontario Steel Company Limited
Laurentienne Générale compagnie d'Assurances
R.W. Lawson
Jacques Lefebvre
Gérard Limoges
Lloyds Bank Canada
Loblaw Companies Limited
London Life Insurance Company
McCain Foods Limited
McCallum Hill Companies
MacDonald, Dettwiler & Associates Ltd.
McKinsey & Company
Maclab Enterprises
MacLaren Advertising
James Maclaren Industries Inc.
Maclean-Hunter Limited
McLeod Young Weir Limited
McMillan, Binch
MacMillan Bloedel Limited
J. Stanley McVicar
Magna International Inc.
The Manufacturers Life Insurance Company
Maple Leaf Mills Limited
Georg Marais
Maritime Telegraph & Telephone Company, Limited
The Mercantile and General Reinsurance Company of Canada
Metropolitan Life Insurance Companies
Midland Bank Canada
Les Minoteries Ogilvie Ltée.
Mitsui & Co.
The Molson Companies Limited
Montréal Trust Company of Canada
Donald S. Morgan
Morgan Stanley Canada
Murphy Oil Company Ltd.
The Mutual Life Assurance Company of Canada
Nabisco Brands Ltd.
National Trust Company
Nesbitt Thomson Deacon
The New Brunswick Telephone Company, Limited
Newfoundland Telephone Company Limited
John Nichol
Louis-Paul Nolet
Noma Industries Limited
Noranda Inc.
Northern Telecom Limited
Northwood Pulp and Timber Limited
NOVA, An Alberta Corporation
Onex Package Inc.
Ontario Hydro
PCL Industries Limited
PanCanadian Petroleum Limited
Jacques Parizeau
Charles Perrault
Petro-Canada Inc.
Phillips Cables Limited
Laurent Picard
Claude Pichette
The Pioneer Group
Polysar Limited

Portfolio Management Corporation
Power Corporation of Canada
Prairie Pools Inc.
Price Waterhouse & Co.
Procor Limited
ProGas Limited
Provigo Inc.
Public Affairs International
Publications les Affaires Inc.
The Quaker Oats Company of Canada Limited
Quebec and Ontario Paper Company Limited
Québec-Telephone
Raymond, Chabot, Martin, Paré et Associés
Henri Remmer
Retail Council of Canada
R.T. Riley
Robin Hood Multifoods Inc.
Rogers Communications Inc.
The Royal Bank of Canada
Royal Insurance Company of Canada
Royal LePage Limited
Royal Trust
Roynat Inc.
Sandoz Canada Inc.
Sandwell Swan Wooster Inc.
Guylaine Saucier
Sceptre Investment Counsel Limited
Gordon Sharwood
Shell Canada Limited
Silcorp Limited
Société générale de financement du Québec
Société québécoise d'initiatives pétrolières (SOQUIP)
Southam Inc.
Spar Aerospace Limited
Stelco Inc.
Sun Life Assurance Company of Canada
Suncor Inc.
Swiss Bank Corporation (Canada)
Teck Corporation
Téléglobe Canada
Telesat Canada
Texaco Canada Inc.
Thomson Newspapers Limited
Thorne Ernst & Whinney
3M Canada Inc.
Timmins & Associés Limitée
The Toronto-Dominion Bank
Toronto Star Newspaper Limited
The Toronto Stock Exchange
Touche Ross
TransAlta Utilities Corporation
TransCanada PipeLines Limited
Trimac
Trizec Corporation Ltd.
Trust Général du Canada
Ultramar Canada Inc.
Unigesco Inc.
Union Gas Limited
Versatile Corporation
Walwyn Stodgell Cochran Murray Limited
J.H. Warren
West Fraser Timber Co. Ltd.
Westmin Resources Limited
M.K. Wong & Associates Ltd.
Wood Gundy Limited
Xerox Canada Inc.

Honorary Members

W.J. Bennett
Fraser W. Bruce
Hon. J.V. Clyne, Q.C.
J. Douglas Gibson
G. Arnold Hart
David Kirk
Paul H. Leman
M.W. Mackenzie
Peter M. McEntyre
A.M. Runciman
J. Ross Tolmie, Q.C.

C.D. Howe Institute Policy Analysis Committee

The C.D. Howe Institute Policy Analysis Committee (HIPAC), formed in 1980, is an advisory committee whose membership is drawn primarily from businesses and labor organizations that are members of the Institute. To encourage diversity of perspective, HIPAC also includes members from the academic world, agricultural organizations, and the professions.

Off-the-record meetings of HIPAC's full membership take place twice each year. At the meetings, HIPAC members and guests from the public sector hear expert speakers on current and emerging economic and social policy issues, engage in frank discussions of these issues, and help identify the Institute's research program. The professional completion of this program is then supervised by the Institute, in coordination with the HIPAC Executive Committee.

The Chairman of HIPAC is H. Anthony Hampson.

Recent Institute publications prepared in conjunction with HIPAC include:

- *Free Trade Areas, the European Experience: What Lessons for Canadian-U.S. Trade Liberalization*, Observation 31, by Victoria Curzon Price (October 1987). ISBN 0-88806-173-0.
- *Distant Rumblings on the Inflation Front*, Inflation Monitor no. 3, by Richard G. Lipsey and Bruce G. Ewen (July 1987). ISBN 0-88806-171-4.
- *Social Policy in the 1990s: Agenda for Reform*, Policy Study no. 3, by Thomas J. Courchene (May 1987). ISBN 0-88806-138-2.
- *Tax Reform in a New Light*, C.D. Howe Institute Commentary no. 13, by Robert D. Brown (January 1987). ISBN 0-88806-169-2.
- *Confronting Global Challenges*, Policy Review and Outlook, 1987, by Edward A. Carmichael (December 1986). ISBN 0-88806-141-2.
- *Ontario's Proposals for the Canadian Securities Industry*, Observation no. 29, by Thomas J. Courchene, with John D. Todd and Lawrence P. Schwartz (November 1986). ISBN 0-88806-137-4.

Edward A. Carmichael, Vice-President and Director of Policy Research at the C.D. Howe Institute, was educated at Carleton University and at Queen's University and is a former senior economist at both Shell Canada Limited and the Conference Board of Canada. He is the author or co-author of each edition of the *Policy Review and Outlook* since 1983; *New Stresses on Confederation* (1986); *Canada's Energy Policy: 1985 and Beyond* (1984); *Tackling the Federal Deficit* (1984); and many other publications.

Katie Macmillan, Policy Analyst at the C.D. Howe Institute, has degrees in economics from Queen's University and the University of Alberta. She has been involved in policy research for the past ten years, and has written on trade and regional issues for the Economic Council of Canada and the Canada West Foundation.

Focus on Follow-through: Policy Review and Outlook, 1988

What were the causes of the unprecedented decline in world stock markets in October 1987? How will the U.S. trade deficit be reduced and what are the implications for Canada? How will comprehensive tax reform and free trade affect the Canadian economy? What can be done to ease the problems facing Canadian agriculture? The C.D. Howe Institute's *Policy Review and Outlook, 1988* provides answers to these questions and outlines the economic and social policy agenda for the year ahead.

C.D. Howe Institute

ISBN 0-88806-176-5
ISSN 0826-9939